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Meeting of the Federal Open Market Committee

May 18, 1982

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, May 18, 1982, at 9:15 a.m.

PRESENT: Mr. Volcker, 1/ Chairman
Mr. Balles
Mr. Black
Mr. Ford
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Mrs. Teeters
Mr. Wallich
Mr. Timlen, Alternate for Mr. Solomon

Messrs. Guffey, Keehn, Morris, and Roos, Alternate Members
of the Federal Open Market Committee

Messrs. Boehne, and Boykin, Presidents of the Federal Reserve
Banks of Philadelphia, and Dallas, respectively

Mr. Axilrod, Staff Director
Mr. Altmann, Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Mannion, Assistant General Counsel
Mr. Kichline, Economist

Messrs. J. Davis, Ettin, Keran, Koch, Prell,
Siegman, and Ziesel, Associate Economists

Mr. Sternlight, 2/ Manager for Domestic Operations,
System Open Market Account

- 1/ Left the meeting prior to the approval of the minutes of actions and returned prior to the action to ratify System Open Market transactions in Government securities, agency obligations, and bankers acceptances.
- 2/ Entered the meeting prior to the action to ratify System open market transactions in Government securities, agency obligations, and bankers acceptances.

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Mr. Coyne, Assistant to the Board of Governors
Mr. Gemmill, Associate Director, Division of
International Finance, Board of Governors
Mr. Kohn, Senior Deputy Associate Director, Division of
Research and Statistics, Board of Governors
Mr. Lindsey, Assistant Director, Division of Research
and Statistics, Board of Governors
Mr. Robinson,^{3/} Assistant Director, Division of Federal
Reserve Bank Operations, Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat,
Board of Governors

Messrs. Balbach, Burns, T. Davis, Eisenmenger, Fousek,
Mullineaux, Scheld, and Stern, Senior Vice
Presidents, Federal Reserve Banks of St. Louis,
Dallas, Kansas City, Boston, New York, Philadelphia,
Chicago, and Minneapolis, respectively

Mr. Broadus, Ms. Greene, and Mr. Soss, ^{4/} Vice Presidents,
Federal Reserve Banks of Richmond, New York,
and New York, respectively

Ms. Meulendyke, Senior Economist, Federal Reserve Bank of
New York

^{3/} Left the meeting following the acceptance of the report of examination
of the System open market account.

^{4/} Entered the meeting prior to the action to adopt the domestic policy
directive.

Transcript of Federal Open Market Committee Meeting of
May 18, 1982

CHAIRMAN VOLCKER. I want to start off with a couple of special items. The first item is welcoming Mrs. Horn to our little group. This is going to be a slightly abnormal meeting for you, as you will see in a minute. I may be leaving intermittently most or some of the morning. But we welcome you anyway. We have the females gracing the right side of the table except that we have Ms. Greene on the left side of the table to balance it off. The reason the meeting is going to be a little abnormal is that we have a rather abnormal development in the market to say the least. I know very few facts about this, unfortunately, but there is a firm--I guess we'd call it a firm--[involved in] highly speculative [transactions] that apparently has a large and highly leveraged position and can't meet its bills.

MR. PARTEE. It was bound to happen one day or another.

CHAIRMAN VOLCKER. I don't understand it all. They have a big long position.

MS. TEETERS. Is this a dealer?

CHAIRMAN VOLCKER. It's not a recognized dealer. It is a fringe operator who apparently operated in very large size. The varying estimates of his long position are between \$2-1/2 and \$4-1/2 billion. He has been financing himself, or raising capital, with some kind of rinky-dink [scheme], taking advantage of conventions in the market where he borrows securities on the face value of the security; he turns around and sells them and gets the coupon and has pocketed the difference, apparently to finance his other operations. Everything was fine except that the coupons came due yesterday and he didn't have any money to pay the coupons. So, we have a potentially large amount of securities overhanging in the market in a distressed situation, and we're trying to figure out what to do about it. Chase Manhattan is in the middle of this as the middleman in the shorted securities. The people they borrowed the securities from claim that Chase is liable and Chase claims it is not, so we have a [mess] there. Losses are well in excess of \$100 million just on that set of transactions, and we don't know what else is involved; we're trying to find out. I'm told that the bond market was off a little last night and off a little more this morning. I don't know whether it's due to this situation, but if we get a depressed market, I'm afraid we're going to have to support it. At this point, and I assume it's consistent with our Committee rules, I took some steps to get order in the market anyway if it goes off much more. And that's all we've done so far.

MR. RICE. Is this public knowledge yet?

CHAIRMAN VOLCKER. Well, not public in general. I don't know when it's going to come out and when the rumors are going to start. I'm sure there already are some [rumors], but I don't know how many. We'll see that in the market. This [situation] came to our knowledge at four o'clock or so yesterday afternoon. Chase and others held a meeting this morning; they tried to make a pro bono publico contribution [by providing] money to meet this payment yesterday. Nobody else volunteered because they all think it is Chase's

liability. And Chase hasn't come up with [any money] yet. I don't know whether they will.

MR. PARTEE. This is the interest payment?

CHAIRMAN VOLCKER. This is the coupon due. Now, whether there are other financing problems, we just do not know. It just smells as if there may be in this situation, and that's what we're trying to find out. This was pretty much a fly-by-night concern by all indications. They were obviously operating in very large volume.

MR. PARTEE. A fly-by-night concern with \$4-1/2 billion in [longs]!

CHAIRMAN VOLCKER. The latest report is that they "only" have \$2-1/2 billion, so we'll see. But they may be put into bankruptcy for that, in which case everybody who is financing that position is going to be frozen. And it will ricochet back into other financing arrangements, I'm sure, in the government securities markets. So, it could be a very large problem. Ultimately, if there's no other solution, we might just have to stabilize this market for a period of time. At least I can see that as a possible scenario. So, I just took this very preliminary step of keeping in touch with the market if it really goes off. I think the next step, if the market comes under more pressure, is that we'll just have to go in openly and buy some bonds. That is very insufficient knowledge, but it about summarizes what I know, frankly. The other lenders involved in this particular short-selling operation are apparently major security houses in New York. There is a group of 7 or 8 of them; they're all well-known firms. They should be able to withstand the loss if things ever settle, so far as we know about the loss. But that doesn't mean it won't send ripples of very deep concern all through the market. Any comments or questions that I won't be able to answer?

MR. ROOS. Paul, as the Federal Reserve, what is our responsibility in a situation like this--just to keep order? Is that our concern, rather than letting it take its normal course? I'm asking that naively, I really am.

CHAIRMAN VOLCKER. Well, my concern is just a very--

MR. PARTEE. We have a disorderly market clause, don't we?

MR. TIMLEN. We do in the foreign [currency authorization] and I thought we had it on the domestic side, too.

MR. PARTEE. We used to have one fairly customarily; I didn't realize it had dropped away.

MR. BALLES. Maybe we better [adopt] one fast!

CHAIRMAN VOLCKER. Well, we may want to adopt one; I wouldn't suggest that we do so right at the moment. Let's see what happens and we can adopt one if we have to. Our general responsibility is to the economy most broadly, Larry. [That calls for] some judgment about what is good in terms of the economy. The problem in this case, as in all cases, is that the guy who is responsible is only the smallest

part of the problem. If all of the financing arrangements in the government securities market are disrupted, we have a major problem.

MR. BOEHNE. Do you have any idea at this point what other banks are involved or how long the list of banks is other than Chase?

CHAIRMAN VOLCKER. Well, Chase is the only bank involved in this particular operation. But we don't know what else is involved. I suspect there are perhaps many billions of uncleared transactions sitting out there where other banks would be involved.

MR. PARTEE. And the threat, as you see it, is that they may have to dump the government [securities]?

CHAIRMAN VOLCKER. Well, there are two threats. One is that not only they, but everybody else who anticipates the side effect will be dumping; they will sell their own. That's the market effect, which I think can be withstood in and of itself. The more dangerous thing is that nobody will want to finance anybody anymore.

MR. PARTEE. Well, a little caution in financing is not an unhappy development.

CHAIRMAN VOLCKER. "A little" I agree with.

MR. PARTEE. We've known of these fly-by-night operators; I don't think this one fits your description. I don't think it's the one we've been tracking but another one. But, you know, it's one of those things. There are very bad practices in the market.

CHAIRMAN VOLCKER. This one apparently took advantage of the market convention. What I don't know is the [nature of the] financing of the rest of the position--the long position--and whether that's a standard financing operation in which there would be a reasonable margin or whether they cut corners there. The margins [in the market] are all low, but there is some distinct margin. If there is a normal margin on the RPs, there's a little margin of protection. If there is not a normal margin on those RPs, bigger losses are staring us in the face out there from a variety of people we don't know about. There's some indication, and it's subject to confirmation, that the major lenders are New York banks. We may have to get the banks together at some point along the line.

MR. BALLE. Mr. Chairman, although we obviously could make a good case for preventing disorderly conditions in my opinion, just looking at the other side: Is there any risk of our being accused of a bail-out of private dealers or whatever?

CHAIRMAN VOLCKER. Yes.

MR. FORD. I was thinking the same thing, Paul.

CHAIRMAN VOLCKER. There is no way to avoid that.

MR. BOEHNE. They're in the bucket [because of] a skinny premium or cushion; obviously, the cushion has to be a function of what happens in the market. If we go in and protect the cushion, we could be accused of bailing out the banks and the security houses.

CHAIRMAN VOLCKER. That is the nature of being a lender of last resort.

MR. PARTEE. We did very little for Brown.

MR. MORRIS. But the U.S. Treasury has an interest in preserving the market for its securities when it's running a deficit of a hundred billion dollars plus. I think that's the public interest in this market.

MR. MARTIN. And, of course, if we only support the market as it drops, we don't bail out a small margin operator that way. We simply prevent the market from discontinuity.

CHAIRMAN VOLCKER. As near as I can figure out, the short sellers, the lenders of the securities, will benefit from a market drop. But lenders on the long side will be hurt by the market drop.

MR. FORD. Has the Treasury asked us to do anything specifically?

CHAIRMAN VOLCKER. They are aware of the situation. There's no question in my mind that this is a matter of judgment. If it gets bad enough, we can't stay on the side or we'd have a major liquidity crisis. It's a matter of judgment as to when and how strongly to react. We are not here to see the economy destroyed in the interest of not bailing somebody out. The market was still going off the last you heard, Mr. Sternlight?

MR. STERNLIGHT. It was down, but not snowballing. It seemed to be steady at that opening mark of down 1/4 to 1/2 or 5/8 of a point. It was not snowballing.

CHAIRMAN VOLCKER. And there weren't any rumors of this or gossip in the market yet that you were aware of?

MR. STERNLIGHT. Well, I'm sure that a lot of firms are talking about it. I'm sure this is getting around. We were not hearing about it at our Desk, though. I don't know that it was getting out to the extent that it would be on the news ticker.

MR. MARTIN. When you have six principal dealers and several commercial banks and they're all talking back and forth with their lawyers and their accountants, it's out. The question is: How much of it is out and what is the reaction of the market? There are no secrets in this business.

MR. WALLICH. Well, if we have to support the long end of the market, I assume we can undo that at the short end so that we don't change the volume of reserves?

MR. STERNLIGHT. I'm sure that any reserve impact of whatever the Committee decided it was necessary to do in the way of cushioning a decline could be quickly offset.

MR. GRAMLEY. But I'm not at all sure that the objective should be to offset the reserve impact. We're talking about what may well be a marked increase in liquidity preference. And if so, we've

just got to accommodate it. We are looking at an economy that the latest Redbook suggests is teetering on the brink of going over the edge. Attitudes are very, very pessimistic. There are lots of very worried people out there. Add to this atmosphere a financial crisis, and there's just no question in my mind that that is the factor that will push us over the edge. We can't afford to [allow] that. We cannot let devotion to a predetermined path of reserve growth or money growth permit us to commit a major crime against the U.S. economy. It just can't be done.

MR. WALLICH. Well, before we depart massively from our targets, I think we ought to be very clear that that is the situation. We can't start off with that assumption without evidence.

MR. GRAMLEY. But I think the Chairman's approach to this, if I understand it, is to be ready in case the market is not functioning.

CHAIRMAN VOLCKER. That is the approach for now. I just wonder how bad this is going to get and I don't think we can answer your question for the reason that Lyle suggested. If this is a minor thing, and we buy some bonds and the situation calms down, of course, we'll offset it. If it turns into a major liquidity problem--just to put it at the other extreme--we not only want to offset it, we will liquify the market. That's the judgment that has to be made at some point along the line.

MR. PARTEE. [Prices in] the long market have been inching up over the last six weeks. These people must have been pretty deep under water.

CHAIRMAN VOLCKER. That's one of the mysteries of this.

MR. FORD. Are the positions you're talking about mainly in longer maturities?

CHAIRMAN VOLCKER. I wish I knew.

MR. FORD. You don't know?

CHAIRMAN VOLCKER. They're not in bills; they are not largely in bills.

MR. STERNLIGHT. A small part is in bills and a long position of around \$2-1/2 billion is in notes and bonds. We don't have a detailed maturity breakdown at this point.

MR. MARTIN. When Peter says small, he means relative to \$2-1/2 billion!

CHAIRMAN VOLCKER. We are operating in considerable ignorance. But the heart of this problem is not the immediate impact on the bond market; it's a loss to lenders who are not used to taking losses on financing U.S. government securities, to say the least.

MR. MORRIS. And who may overreact to that situation.

MS. TEETERS. When you say bailing out the market and liquifying it, do you mean stabilizing it at some interest rate or letting it move a certain amount? Or have you no idea at this point?

CHAIRMAN VOLCKER. Well, I don't think we can tell; we don't know what the problem is. In the extreme, I think we have to stabilize the bond market. In stabilizing the bond market we might have to liquify the money market in the process; it's at the opposite extreme. We'd pull out every tool we have if we got an extreme enough situation.

MR. FORD. I'm just trying to think through, Paul, how it could foul up our operations in New York. One obvious channel would be if the losses hit the reputable dealers to the point where it imperils their capital position. That would obviously be of great concern to us.

CHAIRMAN VOLCKER. Well, that concern is not foremost in my mind. I don't say it's impossible, if things got bad enough, but the most immediate risk is a freezing up of the whole market.

MR. PARTEE. Do you mean because people won't lend on governments? But they would lend at some margin, wouldn't they?

CHAIRMAN VOLCKER. Well, yes. In a rational world they'd increase the margins a little. We'll see what happens. I don't know.

MR. MARTIN. But if there are bankruptcy proceedings, of course, that begins to freeze assets.

CHAIRMAN VOLCKER. I would remind you that there may be a good many money market funds that are making RPs in the market and it may have been far from their imagination that they or their customers were ever going to take a loss.

MR. PARTEE. It's the risk of the game.

MR. BLACK. I told you all not to trust those M2 figures!

CHAIRMAN VOLCKER. All we've done at the moment is to take a precautionary step. I don't even know whether we've contacted a dealer yet, but we are prepared to contact a dealer if the market seems to show some--

MR. STERNLIGHT. I thought we ought to get more evidence of a really moving situation.

CHAIRMAN VOLCKER. Meanwhile, I will have to pursue whether we should talk to the New York banks or what we should do in this situation. Considering that point, and in the absence of Mr. Solomon who is ill, I will leave this meeting to Mr. Martin for the time being. Are there any other questions or comments that anyone would like to offer at this stage? When I know more facts, I will tell you. We literally don't know whether this is limited in terms of actual losses to Chase or whether the Chase operation is one example of four other messy situations involving this guy.

MR. MARTIN. Where you have one, you have four.

MR. BLACK. It would be my guess that he hit every sort of financing he could get.

MR. PARTEE. They usually do.

CHAIRMAN VOLCKER. One possibility is that somebody is going to put the guy in bankruptcy within a matter of hours and, if he is put into bankruptcy, all those creditors are frozen. And there are a lot of them. Nobody quite knows what will happen. As near as I can understand, nobody has ever tested legally what happens to a repurchase agreement in bankruptcy.

MR. BALLE. If it did go that route, Paul--Chapter 11 or whatever--is there anything that we can really do?

MR. PARTEE. Well, if some positions are frozen, we may have to do some lending at the window, depending on what happens. But I agree with you that we ought to be prepared to cushion the decline and that we should pay not a whit of attention to the position of the guy who is in trouble. And we shouldn't be in a position of seeming to assist the banks in avoiding losses in this case.

CHAIRMAN VOLCKER. Yes, but we can't avoid that implication [unintelligible]; if we do anything, somebody can accuse us of a bail-out.

MR. GUFFEY. What form of [liquification] are you thinking about? Is this an RP merely to help the major dealers carry their inventories? Is it potentially a direct loan or do we just go in and buy--?

CHAIRMAN VOLCKER. All I'm talking about now is the possibility of buying some bonds. But, yes, we may well have to help people with their financing problems. But the market [people] generally are the people directly affected.

MR. GUFFEY. Is that the form of the loan--just RPs?

CHAIRMAN VOLCKER. Using the discount window or an RP, depending upon whether it's a bank or a dealer.

MR. GUFFEY. Well, I assume we could do it with a dealer also through the window if we had to.

CHAIRMAN VOLCKER. Well, if we have to, it could be through the window; but I think we can just do an RP quickly with the dealers. But it's clearly a situation where we may not wish to be constrained by an operating directive on precisely how many reserves to put in on Wednesday afternoon. We may end up putting in one heck of a lot. One can visualize the situation where prices are falling and rates are rising, with the federal funds rate very high and a lot of reserves out there.

MR. MORRIS. We do have the precedent of the Penn Central crisis where we did have to put in a lot of reserves through the window. But a few weeks later that had washed out. I think if we deal with a liquidity crisis early, we can--

MR. TIMLEN. It had reversed itself in about a month to a month and a half.

CHAIRMAN VOLCKER. We can't deal with it too late; and we don't want to deal with it too early.

MR. TIMLEN. But there was also, if I remember, a calm before the storm. Penn Central went bankrupt on a Sunday and nothing really happened until a week later. And then all of the commercial paper issuers had to come in with their credit lines. We put a big bulge [of reserves out through] the discount window and that [crisis] was over by early August, as I remember.

MR. AXILROD. I think that [crisis] was mainly handled, President Morris, by our removing the Regulation Q ceilings on very short [maturities], and the banks ended up financing the [maturing] CDs [with] very little [difficulty] in the end.

CHAIRMAN VOLCKER. Well, we may have overdone it in that case. But that's the judgment one has to make.

MR. MORRIS. In terms of the impact on reserves over a six-month period, there's very little impact left after three months, I think.

CHAIRMAN VOLCKER. There wouldn't be in ordinary circumstances. If we determined that this [situation] gave rise to a change in liquidity preference, for which there is already some evidence, we would want to change the amount of reserves we put in more or less permanently.

MR. MORRIS. That's right.

CHAIRMAN VOLCKER. I don't think we're suffering from a situation where the economy is verging on too much ease.

MR. WALLICH. This [problem] isn't happening because of high interest rates; he's having losses because he was short and rates have fallen.

CHAIRMAN VOLCKER. This guy was apparently a real believer in the fact that rates were going to fall.

MR. PARTEE. He's not the first.

CHAIRMAN VOLCKER. Well, let me go find out what is going on. Why don't you return to the regular agenda if you have no more questions. [Mr. Sternlight and I] will be back.

MR. MARTIN. He was short; he was long. You know how these operations are; they are all over the market. These things are always as complicated as the ingenuity of man and woman can make them.

MR. PARTEE. And lawyers!

MR. MARTIN. Let's proceed with the regular agenda. The first item is the approval of the minutes of actions taken at the meeting on March 29, 1930--I mean March 29-30, 1982 meeting.

MR. PARTEE. So moved.

MR. MORRIS. Was that a Freudian slip, that 1930?

MR. MARTIN. I have to remind you that Freud is out of fashion now. You have to use somebody else! It has been moved and seconded and all are in favor. All right. The second item is the report on the examination of the System Open Market Account. Are Clyde [Farnsworth] and the others here? Just Dave Robinson? All right. Is there any discussion or are there any questions of the operations staff?

MR. PARTEE. I read the report as indicating you had no reservations whatsoever, Dave. Is that right?

MR. ROBINSON. That is correct.

MR. PARTEE. Fine, thanks.

MR. MARTIN. Further discussion? Do we need a formal action?

MR. ALTMANN. Just ask if there are no objections.

MR. MARTIN. All right, if there are no objections, we'll proceed to item three. Gretchen [Greene] is here to report on foreign currency operations since the March meeting. Gretchen.

MS. GREENE. Thank you, Governor Martin. [Statement--see Appendix.]

MR. MARTIN. Thank you, Gretchen. Discussion?

MR. WALLICH. Gretchen, when you described the reaction of foreign central banks to the decline in the dollar, would that reaction be indicative that their concerns over high interest rates really are less based on U.S. interest rates and more on conditions in their own countries?

MS. GREENE. Well, to the extent that some countries are now finding it possible to lower interest rates in their own countries as they feel it is appropriate--Germany is one case in point and Switzerland is another--their immediate concern about the impact for them is not quite so great. However, they recognize that not all countries are in quite as fortunate a situation as they are. And there is concern about the difficulties some countries are continuing to face in servicing their debts and the credit implications of a generally high level of interest rates. So, I think there is still concern, but it's concern of a different type.

MR. WALLICH. Thank you.

MR. PARTEE. The Mexican borrowing was a window-dressing thing until the end of April, as I recall. That is, they had to have a certain amount of cover as of the last day of April. We are more than halfway through May. Does it repeat at the end of May or do they have something that they are doing that will improve their situation?

MS. GREENE. Well, it may still be premature to make a judgment on that. I must say that the Chairman made it quite clear that he did not feel the credit that was extended at the end of April should be viewed as a precedent for subsequent month-end assistance. And the Mexicans are proceeding with their negotiations on a fairly large--I think \$2 billion--jumbo credit. Whether all of this will fall into place in time for the end of May is one of the questions that remains to be answered.

MS. TEETERS. Are they negotiating with banks or with the IMF? With whom are they negotiating for the credit?

MR. PARTEE. Two weeks to go.

MS. GREENE. They're negotiating with banks for this credit.

MS. TEETERS. They have not gone to the IMF yet?

MS. GREENE. They would prefer to be able to handle their problems themselves and to have a program that is sufficiently credible in the market that they can avoid going to the IMF.

MR. MARTIN. Governor Partee, did you have further comments?

MR. PARTEE. No.

MR. MARTIN. Gretchen, a \$2 billion credit would take care of the Mexicans for how long? How many weeks?

MR. PARTEE. What did they need? Was it \$600 million that we [extended]?

MS. GREENE. It was \$600 million that they drew [on the swap arrangement with us].

MR. PARTEE. So, they are \$600 million under water already.

MS. GREENE. They have sizable debt service requirements in the next couple of months. They also, up until the end of April, have been experiencing regular capital outflows, which have had a negative impact on their reserves. I guess one of the questions still before the court is whether they have taken sufficient action to stem those capital outflows.

MR. MARTIN. That's very politely put.

MR. SIEGMAN. Governor Martin, I might just supplement that: Half of the jumbo credit they are negotiating is to consolidate short-term debts, so it doesn't add to their reserve position. And the other half--if it's a \$2-1/2 billion credit or so--would last them roughly one month on their own external payments schedules.

MR. PARTEE. One month!

MR. SIEGMAN. And their latest reserve figures show that they are somewhat worse off than they were at the end of April on their reserve position with regard to their note issue cover. So, if they do receive the proceeds at the end of the month as they hope, they

don't have to come to us for this month. But I think what Gretchen is saying is on the horizon is that they may have to accelerate their borrowing or find some other ways to deal with the issue to rebuild confidence.

MS. GREENE. The borrowing requirements are very heavy; they are estimating their gross borrowing for 1982 at \$20 billion.

MR. GRAMLEY. How has the market reacted to the austerity program, or whatever you wish to call it, that the Mexicans have put into place?

MS. GREENE. I would say that the objectives of the austerity program are welcomed, but there has been some question as to the implementation.

MR. FORD. They're in the middle of an election campaign, are they not?

MS. GREENE. That's right.

MR. FORD. And in Mexico, as I recall the history of that country, traditionally if there is a change in such a period, there is an outflow of investments which come back after the new president gets in. Isn't that the way it usually works?

MS. GREENE. It has worked that way before. And, of course, it doesn't help matters either in terms of the [timing].

MR. FORD. Yes, the timing is terrible. This guy is barnstorming all over the country telling the people the great things he's going to do for them and the question is whether he can [carry out] an austerity campaign under those conditions that satisfies them.

MR. MARTIN. And I think here we're defining austerity as halting construction on four office buildings.

MS. TEETERS. Gretchen, you've given a rather detailed explanation of why the dollar has declined and yet, as far as I'm concerned, it doesn't get there. It seems to me that the dollar declined without any of the traditional reasons as to why international values of the dollar change. Is speculation [the explanation for] what is going on in the market? Is there something other than rational [behavior]? Your explanations only go a little way toward explaining the total turmoil that has been in that market in the past six weeks.

MS. GREENE. I share your view on that. And I answered that question for myself in two ways. First of all, there was considerable selling of dollars by the professionals on expectations of a drop in [U.S.] interest rates, not unlike what we were talking about earlier this morning. Secondly, the talk of a budget compromise was interpreted much more positively abroad than it was here. Most people are unfamiliar with our form of government and think more in terms of a parliamentary system. When they read that the President has reached a compromise with the Republicans in the Senate Budget Committee, [to them] that means that the job is pretty much done. The implication about what that would mean for the bond market was held with far

greater conviction in Europe than it was here. So it was a mismatch, if you like, in expectations.

MS. TEETERS. Are you implying, then, that the value of the dollar will probably rise again, assuming that the domestic situation stays stuck together? If they don't get a drop in rates, will they reverse that expectation and we could see a rising value of the dollar again?

MS. GREENE. Well, as I said, there was some short covering. I didn't make a major point of it because it happened, really, in two days. It happened after publication of the retail sales figures last week and it happened yesterday; but it was sufficient to cut in half the drop in the dollar that we had recorded for the whole intermeeting period. The market is extremely thin. We ourselves had some correspondent business to sell about \$100 million yesterday and we found it very difficult to do that. The reluctance of people to take positions is quite high, so that it doesn't take a very large force to move the prices by a considerable margin.

MR. MARTIN. Further discussion? Thank you, Gretchen. Peter Sternlight is still working on the gathering of information with regard to the situation involving Drysdale Government Securities and its affiliates, and creditor banks and brokerage houses in New York. Why don't we move to Jim Kichline, who is here, and others for the report on the economic situation. Jim.

MR. KICHLINE. [Statement--see Appendix.]

MR. MARTIN. Thank you, Jim. Ed.

MR. BOEHNE. While there are pockets of prosperity in my area, notably in the health area, in general the news is quite bearish. It's grim in some quarters. There are just no signs of recovery. to take an example, has a number of products that they consider leading indicators--and they have been for a number of years--and there's just no life in them at all. In fact, some of them are still going down. If you talk to the economists in some of these firms, they are still optimistic about a recovery later in the year. But if you talk to the top guys in these firms, they may say the same thing publicly, but their attitudes and expectations have definitely soured. One of the things that seems to be at work here is that they see a longer-term deterioration of their competitive position going out into '83, '84, '85, and '86. And that's largely because they're having to cancel a lot of investment plans, given the balance sheet constraint, plus what they see as the high value of the dollar that is putting them at a competitive disadvantage with their foreign competitors. I think the feeling is that even if we got a drop in interest rates soon, which they certainly would like to have, they are really going to be in a very tight spot for a number of years if this situation continues. They see a considerable amount of red ink. So, at least among the people that I talk to in my District, the attitudes--while they weren't good at the time of our last FOMC meeting--are now [focused on] looking out three or four years. And they are saying the damage that the current climate has done is in areas where they think their longer-term competitive position is at stake. And while I think in general they are still supportive of what the Fed is doing, there is some erosion in that support because a

number of them are beginning to think that perhaps the situation is getting counterproductive because of the effect it's going to have on their own competitive positions several years out.

MR. MARTIN. Thanks, Ed. Mr. Timlen.

MR. TIMLEN. I must say with regard to this recession that things seem to be going a little better for the Second District than for our friends in the Midwest. On the one extreme we have Buffalo, where the steel industry, the auto industry, and the auto suppliers are all having a very, very poor time of it, with very high unemployment. If you go over to Rochester, though, they tell you that it is a city with no trough in their peak. Kodak just issued a record bonus at year-end and it helped some car dealers. In New York City, I would say we're all concerned about the thrift situation, but business construction is quite strong in New York, particularly downtown. We seem to have some of that [in the pipeline] through '84. In the City, the service industries are doing well with some minor upset in employment, although I must say the IBFs in New York have not [unintelligible] 20,000 jobs. It's interesting to talk to bankers particularly about what is going on today; they really don't seem to be worried about what they know, for example, about Braniff, Pan Am, International Harvester, and Chrysler. The reaction to the Braniff [announcement] last week was kind of a "ho hum." I must say, though, that the bankers are now talking--in the terminology of the last two weeks--about "survivor loans," which is the only thing that's keeping [some firms] going because of reduced cash flows. Just as recently as last week, the bankers said they were worried about trouble spots that might jump out without warning. And I think we're in [that situation] today.

On a personal note, in Manhattan, and particularly midtown, one can't help but notice the number of small businesses that are either throwing in their keys and closing or going into bankruptcy. I know within three blocks of my apartment, I've lost my favorite Chinese restaurant and my favorite Italian restaurant.

MR. MARTIN. And that's going too far! President Black.

MR. BLACK. I think the point that Ed Boehne raised is one that probably concerns us all. The economists seem to think things are a little better than the businessmen do. I was struck at our last board meeting how differently our directors look at this from the way we tend to look at it. The answer lies at least in part in the fact that they are comparing what they're doing now with what they once did or what they did a year ago, whereas we are looking at the possibility of a seasonally adjusted upturn on a monthly basis. And that's always a problem in interpreting the Redbook figures. They always seem to be the worst right before a turn. I guess I'm a little more optimistic than most people on this, if we continue to make progress on inflation. Of course, I'm assuming away this financial crisis; that would make all bets off. But if we continue in that direction, as I think we will, then interest rates have to turn [down] pretty soon and the upturn in housing that we've had should become still stronger. I would think consumer durables also could change very quickly, and even business spending on plant and equipment could turn around rather fast--faster than any of us has been assuming--if expectations are improved by a decline in interest rates that I sincerely hope is just

around the corner. But the developments that Chairman Volcker informed us about this morning are the main consideration now that could blow it all out of the water. I would have stayed with an estimate about like the staff's of about a 4 or 5 percent increase in real GNP in these last couple of quarters. I believe they're about right on the second quarter. But of course, we're all guessing on this.

MR. PARTEE. You don't feel that the demand for housing might fade as rates come down? There has been a lot of talk to the effect that when rates come down, housing demand will explode again or at least come back very nicely and quickly turn.

MR. MARTIN. It will come roaring back.

MR. PARTEE. But the question is: Are people no longer looking at houses as a source of profits? Are they looking at job instability or income prospects that would make them less willing than they would have been a year ago to pay, say, 13 percent on mortgages?

MR. BLACK. Yes, I think that's a fair assessment. But I still believe we will see some strength there. That [concern] would certainly weaken [the demand for housing]. People no longer feel sure that they're going to make a profit when they sell a house to upgrade. The behavior of house prices has made everybody who has a house worry a little.

MR. MARTIN. Thank you, Bob. President Ford.

MR. FORD. Well, moving down the East Coast, we feel fairly gloomy, as Ed does. We now have in our District, in the supposed Sun Belt area, raw unemployment rates that exceed the national average, which is very unusual for us as you may know. That's weighted for the fact that our two most vigorous states, Georgia and Florida, especially Florida, do have [relatively large] populations. If you weighted it by the population, they would still look reasonably good. If you just take our six states, we now have an unemployment rate that averages just under 10 percent. And that's due to the fact that we have a southern version of Detroit going for us over in Alabama for one thing and the--

MR. BLACK. Pittsburgh II!

MR. FORD. In Birmingham, for example, we are down to one U.S. Steel blast furnace in operation and there's a lot of talk that it may be shut down in June. That would create another problem for us in that area and [contribute to the process of] deindustrialization in Birmingham. Other things that had been sustaining our regional economy are also beginning to waiver. Most particularly, we had the energy boom going for us over in Louisiana--a lot of gas well drilling and so on--and there has been a precipitous decline in that kind of activity. We've had heavy layoffs in oil field drilling operations and related activities there. Most discouraging is the fact that even in our high-tech belt, which is emerging around Atlanta and in Florida, we've had companies such as Scientific Atlanta laying off people for the first time in anybody's memory there. Companies that we think of as having a regular 25 percent increase in profits year after year are starting to feel the pinch. So, things are looking

pretty serious around the southeastern states in our District. The only thing that seems to be encouraging in our area is the fact that we have the World's Fair going on, which is attracting a lot of people to Eastern Tennessee and compensating somewhat for the manufacturing weaknesses in that state.

On the subject of housing finance that you raised, Chuck, while I do think the investment aspect of buying a house is fading somewhat, there's a very strong feeling--I do know a lot of the builders in our area and talk to them regularly, and thrift executives as well--around Atlanta and around the Florida Keys that they are just waiting to get out there. Builders are chomping at the bit. We've had steady increases in permits and housing starts in a number of our major metropolitan areas, although they are still at depressed levels. And I would say our residential markets will come back, though perhaps not with the same vigor as when housing used to be a sure-fire investment as well as a place to live. We have a lot of pent-up demand for housing in Atlanta itself due to some unusual developments there like Georgia-Pacific crossing out "Pacific" and coming back to Georgia. We have a pretty good [housing] market. So, we have some encouragement from that side.

We have another big minus force and that is that farmers in the Southeast are getting clobbered credit-wise--almost like Mexico, you know. The story is that they are overextended on their debt. We're watching the markets for land very closely, trying to detect signals of any kind of collapse in land prices and we're not seeing it because it seems as if the lenders just don't want to liquidate people unless they absolutely have to. So, we're really not seeing a lot of turnover of property, but we are hearing from a lot of bankers in rural areas that they are not happy about their farm loan portfolios in terms of credit quality. And that just reflects the fact that our farmers are having a tough time throughout the District. Overall, I'd say that the bloom is off the Sunshine states in our area, and that except for a few areas of brightness we're feeling the recession pretty heavily. And there is a lot of worry and concern among business lenders in our District.

MR. MARTIN. Governor Gramley.

MR. GRAMLEY. Well, I listened to my colleague Bob Black and I wish I could share his optimism. If we get a budget compromise and get it soon, I think I would go along with his view that we have a potentially good recovery ahead of us. I think we would get a significant drop in bond rates, a pickup in stock prices, improved consumer confidence, and improved business attitudes generally. But I must say that I think the likelihood of getting a significant reduction of prospective deficits before the election is pretty slim. We have to be prepared for the possibility that we will live for 3, 4, 5 more months with this extremely gloomy set of attitudes pervading financial markets and the nation more generally. I don't think that what Bob is talking about is very likely. On the contrary, I see things going the other way in recent months. Plans for business fixed investment are weakening. I had been worried earlier about the possibility of a very, very large decline in business fixed investment, and I thought that the incoming evidence over the winter months had alleviated that concern; now I believe that that [revised] judgment was probably not right. I think we may see further signs of

deterioration in business spending plans in the months ahead. Consumer attitudes are very, very sour. And until that situation is rectified, we're not likely to see a significant pickup in demand for durables.

I'm worried, and worried considerably, about the cumulative effects of high interest rates and what they are doing to the strength of business enterprise. Interest charges are transfer payments; what goes out of one pocket ought to go into another. But I'm afraid the effects on marginal propensities to spend in the aggregate are very, very negative as these high levels of interest rates continue. Ratios of interest to profits plus interest have gone up very, very considerably and they're going up further. And that is clearly having a very substantial effect on the ability of businesses to finance their operations, particularly smaller businesses. I'm wondering if the real danger at this point may not be that an episode of the kind we were talking about earlier will cause credit markets to close in the sense that lenders around the country will suddenly stop lending as a means of protecting themselves against the possibility of very serious effects. That's something we need to watch very, very carefully. I hope the staff at the Reserve Banks will all keep in contact with their banks so that we can understand fully what is going on in credit markets. I think we're going to have to be extremely careful to avoid upsetting the situation, which could precipitate a renewed downtrend in economic activity instead of the upturn the staff has forecast. If I had been in the staff's position, I probably would have forecast just about what they did because that's what I think the logic of the numbers suggests. But the logic of the qualitative evidence coming in suggests that all the risks are on the down side and I think that's what Jim Kichline was telling us this morning.

MR. MARTIN. Thank you, Lyle. President Keehn.

MR. KEEHN. Well, the news from the Midwest, which has been grim all along, continues to be very, very grim. On the agricultural side, though, there has been some very modest improvement from a depressed level. Livestock prices are better; and with the expectation of some improvement on the export side, grain prices could be better. Having said that, farm incomes continue to be very low. Capital expenditures for tractors and combines and the like are exceptionally low. And farm land values declined significantly in the first quarter. On an appraisal basis there are few transactions and when they do occur--and the number of farms for sale is up--the sales are taking place at declines in prices of between 15 and 25 percent. On the industrial side, the District has been in a state of real depression for three years; in terms of employment and unemployment we are comparatively far worse off than the rest of the country. The weakness has now become very pervasive. The number of bankruptcies is going up, particularly among the smaller companies. In the month of March in [our] District there were more bankruptcies than in all of 1981. In the capital sector, railroad equipment is all but dead. Trucks, construction equipment, etc. are in an extremely depressed state. Last week we had a meeting of business economists, which we do on a monthly basis, and the general tone was very, very depressing. In fact, it was generally regarded as the worst session that we have had in a great many years of that particular group. So, to add to what Ed Boehne has said, there is in the Midwest also a deterioration in attitude. The great concern is that the recovery is not at hand

and that, indeed, we could get ourselves into a cumulative downturn here.

MR. PARTEE. I read that Chicago report, Si, as indicating also a giving up in terms of expectations, not just for the next few months, but for the next several years--along the lines of Ed's comment. Was that the sense of the--?

MR. KEEHN. Yes, there's a sense of greatly depressed morale, if you will, about the [near-term] outlook and further beyond. I'd agree with that, Chuck.

MR. BOEHNE. Last month was the first time in my District that I noticed the depressed morale had jumped from, say, the current period, to out over several years. Maybe it has been that way in the Midwest longer, but it just struck me as being apparent in recent weeks in my area.

MS. TEETERS. Si, are you getting a lot of out-migration? Can you measure that in any way?

MR. KEEHN. Nancy, I can't give you a figure as to the number of people actually moving out. Having said that, our employment numbers, as we commented in the Redbook, are just simply atrocious. And the unemployment also is a great deal higher. One would anticipate that in those kinds of circumstances people will leave. But unless there are opportunities in other places that can absorb them, not as many leave as one would expect.

MR. MARTIN. I think both Ed's and Lyle's comments with regard to the so-called "out years" represent a new note in our discussions. I can't speak for the March meeting, but there is a different tone, isn't there? There's a different element that we're considering. President Balles.

MR. BALLE. Well, I can add to the doom and gloom if we need any more, which we don't.

MR. MARTIN. You're the rebuttal, John!

MR. BALLE. It used to be that some of the bad news from the Midwest could be offset by what was going on in the Dallas and San Francisco Districts. We haven't heard from Bob [Boykin] yet but I have to say that as far as the West Coast is concerned, we're no longer recession-proof. We have very widespread weaknesses in all sorts of key industries. It isn't just forest products and it isn't just home building; the weakness has now spread to aerospace, semi-conductors, commercial construction, nonferrous metals, etc. As one example, at Boeing, which I suspect is one of the strongest aerospace companies in the United States if not the strongest, employment a year ago was at 75,000 people. It is now down 2,000 from that level and is expected to go down another 8,000. That's a measure of the extent to which the commercial side of the business is down far more than the defense side is up. About the only recent strength we've seen is in sales of electronic equipment.

Summing all of this up, and pretty much agreeing with what Lyle had to say, it strikes me that even though business confidence is

an intangible and immeasurable, it is really worse than the business statistics. It's worse than what we might expect in terms of patterns of cyclical recovery. And that is really bad news. I'd say that among our five offices, about a fourth of our directors, including the bankers who see spreading loan delinquencies and problem loans or non-performing loans, are now so concerned that they're proposing that the Fed either operate at the top of its monetary growth ranges--and some would say we should go above those ranges deliberately for whatever period is necessary--because of the cumulative damage being done to all sorts of business concerns and individual consumers by the high level of interest rates. They are as worried as I've seen them in my 10 years on this job.

MR. MARTIN. Thank you, John. President Roos.

MR. ROOS. Well, I guess inevitably I just don't reflect what happens everywhere else around this table. In our part of the Midwest I don't sense the pervasive gloom that some of you are reporting, and we have had CEOs of major corporations in the Bank just within the last two weeks. I sense a general feeling that the economy is near the trough of the recession; I sense a rather positive recognition of some fundamental things that most of our people feel have been put into place. First of all, they're comfortable with the level of inventories; secondly, they are extremely pleased about the downward trend of inflation; thirdly, they see a stabilization, or an absence of further downward movement, in the economy. The basic feeling is that the economy has hit the bottom that was anticipated. The one point that comes through to me constantly is this plea: Please tell your colleagues that the one thing that could push us over the brink is if [monetary policy] becomes expansive because that would move interest rates up. In other words, the basic feeling is that we're down the road in our cure process and they anticipate a recovery and hope that we, in our infinite wisdom, don't do anything to upset that recovery. I would just say, as a relatively senior individual about to go out to pasture, that I can remember every time in the short seven years I've been here that when things were just about to improve a great many of us were saying "Oh my word, we're facing absolute disaster. A couple more months and if we don't intervene in some way, everything is going to go down the drain." Well, I think we're on the brink of improvement [as do] most of the thinking people in our part of the country who are out of the realm of politics. I think the politicians on either side always will be overly optimistic or overly pessimistic because that's how they do business. But there is basically a subdued confidence, as I sense it, in our District.

MR. MARTIN. Thank you, Larry. We at last had a rebuttal of some kind.

MR. ROOS. I wish I didn't have to be the guy to do it.

MR. MARTIN. Governor Rice.

MR. RICE. I don't want to add to the doom and gloom either, but I do have to say that I agree with a good deal of what has been said on the pessimistic side around the table, and I share a good part of the view expressed by Governor Gramley. Although the economy appears to be declining at a slower rate, there is no obvious and convincing evidence that it is bottoming out at the present time or

that an upturn is close at hand. The main concern that I have, therefore, is with respect to the timing and strength and possible duration of the upturn--specifically whether we will have to wait for the stimulus we'll get from the midyear tax cut or whether the inventory correction will occur before then and provide the spark for the upturn. I rather doubt that we will see a substantial buildup of inventories in the current environment. I agree with what has been suggested by several people: namely, that the stress in the economy is probably understated by the macroeconomic figures. The data we look at probably don't reflect fully the strain and stress that a lot of business firms are feeling, particularly the debt-laden business firms. And as Lyle pointed out, many of these firms are experiencing the stress of a rising ratio of debt [service costs] to profits. In this environment, I don't think we are likely to see a strong buildup of stocks. So, from my point of view at least, it appears that we will have to wait for the stimulus stemming from the midyear tax cut, which we may not feel until some time further into the third quarter. Of course, that longer delay in the upturn will increase the stress on firms and their vulnerability to failure and bankruptcy. Although the reduction and the elimination of inflation continues to be our primary goal and a matter against which we mount a determined struggle, I think it is obvious in the present situation that we have made a good deal of progress toward reducing inflation and that we've made enough progress so that we can now look around and survey the damage that has been done to the economy. It's also time, I think, to see what we can do to allow the economy to repair some of this damage.

MR. MARTIN. Thank you, Emmett. Comments? Are you commenting on Emmett's remarks or making a separate statement.

SPEAKER(?). No, a separate statement.

MR. MARTIN. Would you mind if we went to President Guffey first? President Guffey.

MR. GUFFEY. First of all, I'd like to direct a question to Jim Kichline. If I understood your comment, Jim, the Greenbook is based upon an assumption that there will be a budget compromise and that it will be in magnitude about half what the President has recommended. I was under the impression that the assumption had been that there would be no compromise.

MR. KICHLINE. No, in February we had taken roughly half of the proposed deficit-reducing measures in the Administration's budget at that time. We have retained that [assumption]; those numbers on a unified deficit basis are around \$25 billion in deficit reducing measures both on the tax side and in expenditure cuts. The numbers being talked about in the Congress--adjusting away some of the things such as interest rate declines, which we have not put into these measures--are in the \$50-\$60 billion range. So, we're at roughly half of what is being talked about in the Congress now.

MR. GUFFEY. Is that for the remainder of calendar year '82?

MR. KICHLINE. No, that's for fiscal '83.

MR. GUFFEY. Fiscal '83.

MR. GRAMLEY. What do you assume about cuts further out? It seems to me that the critical issue in terms of the effect on the economy of a compromise is what happens to expectations about further growth of the deficit beyond fiscal '83. What does that mean for long-term interest rate expectations, not just for long-term interest rates now. If one were to assume that we had that kind of deficit reduction for fiscal '83, but much much more in '84 and '85, then I would be quite convinced that the economy would come out of its current slump and turn up. But if that were the only action--a cut in the deficit of \$40-\$50 billion or somewhere around there--and if that were the figure for deficit reductions in '84 and '85 also, then I don't think we'd get much relief.

MR. KICHLINE. Well, we have not, as you know, explicitly forecasted '84 and '85. I think it's perfectly consistent, however, that whatever is done in the Congress would imply larger [deficit] numbers in subsequent fiscal years. In this forecast, however, we have the persistence of very high long-term rates. One of the difficulties, frankly, is that what is being talked about in the Congress is probably not sufficient to induce market participants to believe that things are going to get done in a sizable way. Those numbers are most discouraging. To look at specified cuts: The Congress has raised once again [its estimate of the] sales of outer-continental shelf leases. Frankly, it's running the other way. The Administration has reduced the numbers, but the Congress wants to get the deficit down so they say that the United States is going to sell \$8-1/2 billion of those in fiscal '83. Even the Administration doesn't buy that number. I can only say that no matter what the numbers are, if one goes through this line-by-line, it seems to me that the program has to be credible in order to have the kind of impact that you're talking about. And I really don't see that on the horizon. Dramatic things are going to have to happen over the next few months to change this around.

MR. GUFFEY. If I may [continue], Governor Martin, there are three or four major economic activities in the Tenth District that I'd like to comment on: the aircraft industry, energy, agriculture, and auto assemblies, the latter being a very big employer in our District. Starting with the aircraft--and I'm talking about the Cessna, the Beach, the Lear jet, the Boeing aircraft--operations essentially are dead in the water, if you will, with simply no sales on the horizon. They are completing their contracts and as a result some unemployment is beginning to show up and quite likely will run out even into the recovery period. In the energy field, the number of rigs operating is down something on the order of 18 percent, May over January. And that suggests some layoffs in that industry, [and with] less piping and other supplies it rolls back to other industries. But the fact of the matter is that that has been a very vigorous sector of our economy, and some downturn perhaps is not unexpected. I would observe also that even with an upturn in the economy in the third quarter or perhaps the fourth quarter, that problem won't be solved simply because it stems largely from the glut in the international market and from the stock markets. [Given] the stock market prices, the numbers just will not work. So, until the oil prices come up on the international scene, we won't see a lot of improvement, but I don't think the downturn will go much deeper. In the auto assembly area, it is well known that there is unemployment, and that sector probably will not come back until the economy recovers.

In the agricultural sector, Si Keehn accurately described the situation with respect to some optimism in the livestock area. Prices have increased rather substantially over the last 30 days. That's a segment of the agricultural industry and, to be sure, the improvement is welcome. But on the crop side, there is a glut; there is an overhang in the supply. We are looking at a very good crop and, as a matter of fact, there is no optimism in that area; unless we get the dollar in some better alignment internationally and pick up the export sales, there isn't much hope for substantial improvement. Just to give you an order of magnitude: Net farm income last year was about \$23 billion; they are estimating \$15 billion this year. And when taken in real terms in 1967 dollars that's almost the present level for the agriculture industry. Having said that, however, the best estimate is that there will be only about a 4 percent withdrawal of operators during this year. In other words, this year will be a washout. They have about one more year of [unintelligible] before we will see some very disruptive developments, such as sales of farm land and equipment in large numbers.

In summary, there are some difficult spots. We are in a position in the Midwest where, because of the nature of agriculture to begin with and the energy area, we can weather another 9 months to a whole year fairly well. Lastly, in the energy area, I'd say that the announcement by Exxon of the close out of the shale oil [development] on the western slope of the Rockies, which was a surprise to everybody to begin with, will have some economic impact, estimated to run something like 10,000 in unemployed in that industry in Colorado. That probably won't impact the state, which is a small state and sparsely populated in some areas, to the extent of 10,000 employees simply because those are employees who have been attracted to the area and who quite likely will go home. But it will have a major impact on the economy in that western area.

MR. MARTIN. Thank you, Roger. Governor Wallich.

MR. WALLICH. It's difficult to evaluate the qualitative gloom against the quantitative evidence, such as it is. I wonder whether one reason for the great gloom is not the disastrous profit [experience] that people have been through in the first quarter. Profits collapsed in the first quarter, as one can see from our data, and that is bound to impress people when the details come out; when corporate reports go out, we may get some further impact from that. But it seems to me we experienced this kind of psychology too in 1980, and then we were in the worst recession since World War II. The economy was going down 10 percent per year. Nothing seemed able to stop it. As we know, it was "coldest just before daybreak" and it may turn out that way again. There was a big difference in 1980. We had allowed interest rates to fall very sharply and that turned housing around very fast. That [sort of rate decline] has not happened this time and to the extent that it was [induced by] policy, I think it was the right policy. It is somewhat surprising that we're not getting the declines in interest rates that one would expect, given the rate of inflation. But if the economy continues weak, that in itself, of course, would be a factor making for lower interest rates and for an improvement in housing.

Now, the elements of strength in the situation, I'm sure we're all are familiar with. I wish we didn't have to count on the

large tax cuts and social security increase as a kicker to the economy. The upshot of all this is that hardly any forecasters are seeing a decline even for the second quarter. After all I've heard here, one would expect the second quarter to be a disaster like the first, or worse. Our projection is coming down, but is not yet negative; even if the second quarter were a small negative, which wouldn't surprise me, the decline would be slowing. I find it difficult, with all these elements [of strength] ahead for the third quarter, to think that we are facing a great risk of continued decline [in overall economic activity]. What we're facing, I think, is the prospect of a very moderate advance and the possibility of choking that off. The possibility of the economy going down, barring a financial crisis such as we've talked about here today, seems to me the lesser probability. Thank you.

MR. MARTIN. Thank you. Bob Boykin.

MR. BOYKIN. I think it would be fair to characterize our economic situation in the Southwest as somewhat sluggish. The oil sector is still in decline; the rig count was down further in April. But there does seem to be a growing feeling that [the oil sector] is probably near the bottom if it's not there, much as Roger indicated [for his District]. Refining operations are below capacity utilization, and unemployment in that sector is down about 12 percent since December. We have had a little pickup in housing starts, but they are still at a low level. Unemployment in the State of Texas rose to 6.4 percent in April and that causes us some concern. We are not used to those kinds of numbers. Growth in bank credit slowed in the last couple of months. The demise of Braniff recently, while it might not have made a ripple in New York, caused quite a bit of consternation down our way. In fact, I wasn't sure I could get here for this meeting.

MR. PARTEE. You could rent one of those planes!

MR. BOYKIN. In our immediate area that involved about 4,600 jobs that disappeared overnight. On agriculture, again I think Roger described that very well. Our commercial construction seems to be holding up fairly well. There have been some pullbacks on announced projects but there are still a lot underway and some of the larger [announced] projects still plan to go ahead. In a subjective sense, I read the comments of the people I've been visiting with very recently much the way Larry Roos is reading them. Attitudinally, I think the feeling is that if we can just make it [through] another 3 or 4 months, the picture is probably going to look a bit better. I've not heard the concern that you were expressing, Ed--that you are now beginning to hear [expressions of] pessimism about the longer term or "out years." Just to end on a positive note: One straw in the wind is that my favorite retailer--some of you know he deals in luxury goods and in fact he says he sells absolutely nothing that anybody needs--did give me a call just to update me. He said he was a little disappointed that instead of his usual 30 to 35 percent monthly increase, it had dropped to about 17 or 18 percent. He attributed it to the peso devaluation. But he said that in looking at the reports that had arrived in the last two days, he thought maybe that had turned around too.

MR. BLACK. Is that stock publicly traded in their name?
[Unintelligible] a chain.

MR. MARTIN. At a risk, I've been desperate to close on a positive note for the coffee break. And if two or three of my colleagues will indulge me in this, let us adjourn on that 17 percent upbeat note.

[Coffee break]

MR. MARTIN. Ladies and gentlemen, the Chairman has asked me to pass on a comment. He will be joining us in a few minutes so that we can hear from Peter and Steve, who are still involved in the Drysdale meeting next door [in the Chairman's office]. He asked me to indicate to you, knowing that you might want to change airline reservations or whatever, that it looked to him as though it would be necessary to reconvene the FOMC after lunch. So, I'm passing that on to you from their meeting. We have a number of people who have comments to make. If the Chairman is back by then, we'll hope to hear from our market-related colleagues. Let me recognize first Governor Partee.

MR. PARTEE. I don't know that I have very much to add to what was said before the break. I'm not optimistic on the business outlook. It seems to me that the new factor is the possibility of a distinctly deeper drop in capital spending than we have been looking at. I would point out to you that the surveys have been progressively less good. The McGraw-Hill survey now shows a sizable decline in real capital spending for the year. And when you talk to businessmen and look at the Redbook and things like that, one gets a sense that there is a very substantial conservatism that is now being introduced into the management of companies and that cash positions are a little strained. But I also have to admit that I have some sympathy with Larry Roos' point. This is a painful, difficult period that we're going through. We expected that, I think; at least I certainly did. It is necessary to squeeze profits unmercifully, Henry, in order to get businesses to cut their costs and become more efficient and to resist wage increases of size. And in the process, we're going to have some business failures--quite a few failures. We have a whole regime of business enterprises that had heavy debt ratios and were banking on inflation. Now that we're not going to have inflation because that's our official posture, they are going to have to fail. It may be a sizable proportion of the business community and it may include quite a few government securities dealers and people who speculate in securities of various kinds. We just have to take these kinds of things as they come because what we want to do, if I understand it--and what we've put the economy through hell for over the last 2-1/2 years--is to reduce inflation. So, let's get the inflation reduced and let the people suffer who are going to suffer as a result. At least that's my view.

One caveat that I think is important was expressed at the last Academic Consultants meeting that we had. Somebody said that the recession in 1929 didn't look too bad for the first 9 or 10 months; one might reasonably have thought after that period that the economy was going to recover and would be all right. But there was a second-tier decline. And that was much sharper and it occurred because of financial collapse. So, if we really do have a crisis here with this

firm, or if a crisis developed that tested the very financial fabric of the economy. I think we would have to deal with that. But short of that it seems to me that all we're hearing--and there's a considerable amount of it--is the pain that occurs when we have more than just a temporary little recession within a secular upward movement [in the economy] and instead have something that is going to affect a much broader number of people, businesses, profits, etcetera. So, I'm alarmed, but I'm not yet panicked.

CHAIRMAN VOLCKER. We can turn to Mr. Axilrod. I guess that is where we are, right?

MR. RICE & OTHERS. We haven't heard from Mr. Sternlight.

CHAIRMAN VOLCKER. Oh, you haven't had that report yet? Well, we will turn to Mr. Sternlight. That reinforces my feeling that we may run over into this afternoon.

MR. STERNLIGHT. It all seems anticlimactic, Mr. Chairman. [Statement--see Appendix.] And, of course, in the wake of this other securities firm that is in great difficulty today, there's an additional great note of caution about financing arrangements even for the highest quality of credits.

MR. BLACK. Peter, you say the "other" firm. Was that reference to still another firm? When you talked about the uncertainty in the market rise earlier--

MR. STERNLIGHT. When I mentioned that I was talking about the Drysdale situation that the Chairman spoke of [earlier].

MR. BLACK. I thought for a minute that you might be talking about another firm.

MR. STERNLIGHT. No, that was the one I was alluding to. That concludes my statement.

CHAIRMAN VOLCKER. I didn't mean to cut off Mrs. Teeters and Mrs. Horn from the earlier discussion.

MS. TEETERS. As far as I'm concerned, we can go ahead and have the presentation on the alternatives and I will make my statement then.

CHAIRMAN VOLCKER. You'll make your comment later on it.

MR. BALLE. Since I was on the daily morning call for most of the days since the last FOMC meeting, I just want to make a brief observation. I think we gave the staff an unusually challenging assignment for all the reasons you know about, including the seasonal problem with M1 in April, etc. From my perspective, I want to say that both the engineering and the execution under Peter and Steve and their staffs was just really great. There were some nervous moments, at least on my part, around the middle of the month when the projections showed a 14 percent rate of increase in M1 in April and a 12-1/2 percent rise in M2. But, fortunately, that calmed down as the later projections were revised downward and we came in almost smack on target for April, which was an extraordinary and fine achievement.

MS. TEETERS. Could I ask Peter a question? You said that the Treasury cash balance went up to \$30 billion. Is that an unusual increase?

MR. STERNLIGHT. Oh, yes. I would think that was very likely a record. It had been quite high in February, and we had something of a problem of the Treasury's Fed balance having to go up to about \$7 or \$8 billion then when the Treasury's [overall] balance had gotten up into the mid-\$20 billion area. But when it got up to nearly \$30 billion overall, the balance at the Fed went up to a little over \$12 billion for a few days.

MS. TEETERS. So there really was a very large final settlement--well above normal--in the first quarterly payment.

MR. STERNLIGHT. Yes.

MS. TEETERS. That would probably explain some of the run-up in NOW accounts that took place in anticipation of April 15.

MR. STERNLIGHT. That could be. I don't know.

MR. PARTEE. Peter, was the currency shipment to Argentina a noticeable factor?

MR. STERNLIGHT. Well, in the last report I had received on those currency shipments to Argentina, they totalled about million from the beginning of April up to then, which was about a week ago now. So, it's not a very big deal [in relation to M1]. The estimate that I saw was [an addition of] about percent to M1 growth in April. Of course, for those who look at currency growth or who follow the monetary base closely, there would be more of a difference in those measures.

MS. TEETERS. Does this imply that Argentina is about to become a two-currency country like Mexico?

MR. STERNLIGHT. I don't know.

MS. GREENE. The information I have on that, which is anecdotal only, is that there was great concern. Well, first of all, there are some dollar deposits in the banking system in Argentina. And what was happening was that depositors were taking the dollar deposits and cashing them in for notes out of concern that the deposits might be expropriated in some way by the government and that the notes under their mattresses would be more secure.

CHAIRMAN VOLCKER. We'll turn to Mr. Axilrod at this point. Excuse me, I forgot that we have to confirm the operations.

MS. TEETERS. So moved.

CHAIRMAN VOLCKER. Without objection. Now, Mr. Axilrod.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Well, we had a lot of "whereas" comments in this report on the possibilities, anyway. Mr. Morris.

MR. MORRIS. Steve, you assume that the impact of the sweep account is certainly going to be to reduce transactions balances. I think that will be the effect in the long run, but it seems to me it is possible that in the short run it could have the opposite effect.

MR. AXILROD. Oh, yes. It could--

MR. MORRIS. The banks seem to be marketing them, at least initially, in a very conservative way, and people may still be willing to keep more in their NOW account as a price for the convenience of combining the money market funds with their deposit account. In short, we could have an increase in M1 as a consequence.

MR. AXILROD. I think that's possibly quite right.

MR. MORRIS. It could be very troublesome.

MR. AXILROD. It depends on whether we get the very large accounts into the sweep accounts, and whether that is offset by people building up balances in the smaller deposit accounts.

MS. TEETERS. Frank, is this because there is a minimum that one has to--

MR. MORRIS. Yes, one has to have a minimum balance.

MS. TEETERS. And those minimum balances are fairly high?

MR. MORRIS. Well, let's say there's a fellow who normally keeps \$2,000 in his bank account and \$10,000 in a money market fund and the bank offers him a deal where he can consolidate them but he has to keep \$2,500 in his bank account. So, his M1 balance goes up by 25 percent. And he's willing to do it because of the increased convenience. If this is a typical account, then we could see a ballooning of M1, which could be very embarrassing to say the least.

MR. BALLES. I might add, Frank, that one of our largest S&Ls on the West Coast just announced a sweep account and it started at a \$2,000 minimum balance. So it isn't limited just to banks.

MR. MORRIS. Competition will tend to bring those balances down over time, but in the short run they may be pretty high.

CHAIRMAN VOLCKER. Well, who would like to comment on this statement and on this great economic monetary policy problem?

MS. TEETERS. May I take my turn now? I have listened very carefully, and I get a strong sense of crisis--which I've been anticipating for quite some time--not just in financial markets but in practically every sector of the economy now. No particular region seems to be exempt. Even if today's problems with the money market are resolved successfully--and we don't have any clue on that as of this point--I think there is another in the wings. Whether it's a particularly new and inexperienced or maybe dishonest broker or whether it's one of our larger firms, we are going to be facing financial crisis sooner or later. I would hasten to point out to you that since we last met we've had five major bankruptcies, all anticipated. Braniff may not have disturbed New York but it obviously

disturbed Dallas. We have a list of close to 75 major corporations that have had their credit ratings downgraded. And since that list came out, there have been three additional bankruptcies reported. There are other firms that are obviously very shaky and that have very high debt [levels]. I think much of this crisis and the problems, both in the international market and the domestic market, have come from the high variability of interest rates. And I think people have built into the interest rates now a margin for risk, which reflects that variability. And the variabilities also have created new markets that I don't see any function for except for variable interest rates. Those are the futures markets, the options, and the ultimate silliness--the options on futures, which strike me as just pure gambling or trying to avoid risk.

So, it seems to me pretty obvious when one looks at the economic projection, which I don't disagree with, that we are in the process of just pushing the whole economy not just into recession, but into depression. And that's not a forecast of a good economy, I would point out to you. It seems to me utter foolishness to have 9.4 percent unemployment and a 15 percent federal funds rate. Those are just two things that have never occurred in this economy before. The staff has lowered its forecast, and has done so across the board, although mainly in business fixed investment. But everything is down. And when I questioned them about it yesterday, they said "We no longer can deny the April numbers." The April numbers are very bad. And they carry that forecast of very slow growth out for a longer period of time. If you look at it closely, there is no recovery. By the time we get to the fourth quarter of 1983, the unemployment rate is down to 8.8 percent and capacity utilization is up to 73 percent. I think we've undertaken an experiment and we have succeeded in our attempt to bring down prices, although I realize they are lower than can be sustained. But as far as I'm concerned, I've had it with the monetary experiment. It's time to put this economy back together again and to get us some stability as to where we're going and how our interest rates are going to operate. I have very little respect for the long-term aggregate [ranges] and I don't feel we have to prove ourselves any more. I think it's time to operate as rational people and to try to get the economy at least started on a tentative recovery.

Given the alternatives that Steve has presented, that leaves me in the position of alternative A. I can't conceive of maintaining these interest rates and not having really severe problems as we move into the summer. I'm concerned, as is everyone else, about those deficits. I would hasten to point out to you that approximately \$100 to \$125 billion of the deficit is due to the recession. And I don't think we should require the Congress to try to offset recession-induced deficits by cutting expenditures or raising taxes. Even if we adjust for that, the deficits are substantial. And that's what I assume the Congress will be working on rather than trying to remove the other part of it. I think it's time to relax [policy] and to reliquify the economy. It's time to permit corporations to fund their securities loans. It's time just to say we are finished one job and to start the next one.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think everyone agrees that the economy is in a bad predicament now and that lower interest rates are a prerequisite for any kind of sustained recovery. But where we have the point of difference is how we think we ought to get those rates down. It seems to me that there are two main reasons why rates are staying up. The first would be the uncertainties concerning what might be done by Congress on the present budget impasse; I guess all we can do in that area is to jawbone, as I think you've done very effectively from time-to-time, with the rest of us chiming in whenever we could. But the second reason is a fear that the System at some point may be forced toward some materially easy monetary policy. And against this background, I think the best way to reduce inflationary pressures, and with them interest rates, is to get these monetary aggregates back within the target ranges and keep them there for the balance of the year. So, I think we ought to stay with "B," which we adopted last time. But I would regard that "B" part on M1 as the upper limit. I would be glad to accept maintaining the language in the directive about a lower rate or an actual decline in M1, if that's accompanied by substantially reduced pressures in the money markets.

I have two other points. The first is that I would be a little concerned about leaving in the sentence in the directive regarding M2--the second sentence in the operational paragraph. We included that last time mainly to cover the effects of the tax-related flows into M1, and we are now well past the tax date. And I wouldn't want to see M1 come in above the "B" specifications even if M2 were on path. The second point is that paragraph 10 in the Bluebook states that the staff's best estimate is that an \$800 million borrowing level would be compatible with "B." The borrowing level in the first four-week period of our intermeeting period averaged \$1.3 billion. And since the demand for borrowings is notoriously volatile, I think it would be a little better to start out a bit more conservatively. For lack of a better figure, I would throw out \$1.1 billion. And then I'd have a clear understanding with the staff that borrowing would be adjusted down quickly if new data suggested that we had greater-than-anticipated weakness in the money supply and a lessening of pressures in the money market.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, as Chuck said, we have been putting the economy through hell. I think maybe a drop of water would be helpful to those poor souls in hell at this point! So, in my view, we've reached the point where we ought to put some downward pressure on rates. Something between "A" and "B" captures the spirit of what I have in mind. I would have borrowing in the \$600 to \$700 million range, with a federal funds range of 10 to 15 percent. I would, however, keep the aggregates figures for March to June the same at about 3 and 8 percent [respectively for M1 and M2], with the understanding that if M1 is a little on the high side, that would not be a great concern.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I attended a meeting of central bankers from around the world at the New York Federal Reserve Bank last week, and the various countries explained how they are controlling the money supply. The fellows from the Bundesbank

criticized the Japanese for being too pragmatic in that they don't have any monetary guidelines or don't seem to have any rules that we know of and are just pragmatic. And the Japanese said: "Well, let us compare the inflation rates in Germany and Japan and let us compare the real growth rates in Germany and Japan. They said, in effect, that maybe there is a case for pragmatism occasionally in central banking. And I tend to feel that way at the moment. We are in an unprecedented period in that we've never been in a recession with interest rates like this. We've never been in a recession where our corporate sector was not only unable to liquify its position and to structure out its debt, but found itself needing to increase the level of its short-term debt during the recession. So, it seems to me our ability to forecast the economy is pretty limited in this unprecedented period and that, therefore, a pragmatic case can be made for erring a bit on the side of ease at this juncture. So, I would support alternative A.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Let me say first of all that my preference would be alternative B, that is, retention of the second-quarter targets that we set last time and for the "B" proposal with respect to the intermeeting period of May and June. I would like to pose a question to Steve with respect to the \$800 million borrowing assumption associated with "B." It isn't clear in paragraph 10 on page 7 whether or not we start the period at \$800 million or end the period at \$800 million or whether that is the average over the intermeeting period.

MR. AXILROD. Well, President Guffey, what we try to do--if I could take a minute [to provide some] background on that--is based on the results of a study we did a year ago. We try to estimate the rate of interest that would be consistent with the intersection of the money supply target with what we perceive to be money demands over that period. And then, given the discount rate--that rate of interest in here we think is a little lower--that implies the level of borrowing. So, we construct the total reserve path on the money supply target and project, in effect, what we think is the proper interest rate in order to say what the demand for borrowing consistent with that path would be. And that's how we got to the \$800 million, given the discount rate. That, in effect, is what we think the sustained amount of borrowing would be over the period.

MR. GUFFEY. On average?

MR. AXILROD. Yes, and consistent starting out if we're right. Of course, we might very well be wrong in our interest rate projection, but that's a way--just as a first step--of trying to derive a nonborrowed path consistent with that total reserve path.

MR. GUFFEY. If that's the case, then it's my judgment that starting with-- Well, first of all, let's say that we have something like a 14 or 14-1/2 percent federal funds rate at the moment with a borrowing level of about \$1 billion, which was the level last week as I recall. If we're moving then to construct the paths commencing with an \$800 borrowing level, then I would suggest that "B" does imply a rather quick downward shift in interest rates. My best judgment is that your [estimated decline to] 13-1/2 percent for the federal funds

rate over the intermeeting period may be a little modest. It might be quite a bit lower than that.

MR. AXILROD. May I just make one comment that I think is relevant, particularly in this recent environment? What we have experienced very recently is a little less borrowing and the funds rate just coming down. Before that we had a higher funds rate than we thought [likely] for the level of borrowing. I'm not at all certain that the banking system feels that eager to borrow. If we ever got into a liquidity pressure situation, it may be that they'd want to store up their goodies a bit. So, I'm not exactly certain. It could go that way. I'm really just not certain, President Guffey.

MR. GUFFEY. Well, just in conclusion: "B" is attractive to me, and my own feeling is that a path built upon these dimensions will give us a lower funds rate rather quickly, which will give the kind of relief that I think some around the table are suggesting may be necessary. I would hate for us to give up the quarterly target [for M1], however, at the 3 percent level.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Well, I'd like to express myself in terms of realities. I would question very vehemently any implication that monetary policy in the last few months has really been as tight as some would imply it has been. Even if money growth from April to June is zero, second-quarter growth of M1 will be somewhere between 3 and 4 percent. And when combined with the first-quarter M1 growth of 10.7 percent, that would result in money growth of 6-1/2 to 7 percent for the first half of 1982. That is not starving orphans; it is not squeezing the economy to death. It is relatively robust growth.

I would opt for "B" because I think it would set the stage for M1 growth of about 5-1/2 percent for the second half of 1982, which should allow for positive growth of real GNP. Even though that rate of growth, when combined with the 6-1/2 to 7 percent growth in the first half, would produce approximately 6 percent M1 growth for the year as a whole, which is slightly above our annual target, it would still work toward reducing the basic rate of inflation from the current 7-1/4 percent. If we were to opt for an expansionary policy of something along the lines of alternative A, I think we would most assuredly end up with 6-1/2 to 7 percent growth of money in the second half of this year, and that sort of money growth would reignite inflationary expectations and start to undo the progress we've made over the past year and a half. The consequence is--and apparently there is some difference of opinion and difference of understanding on the part of some of us on this Committee--that the inflationary expectations resulting from an expansive monetary policy would cause interest rates to rise, and I underscore rise, rather than fall.

Finally, while I don't want to get into a philosophical discussion and would rather imply my attitudes toward this, I couldn't characterize monetary policy as it has been conducted as entirely a failure. It has gotten us from those glorious double-digit inflation days that apparently some enjoyed a few years ago to inflation at a tolerable rate. It has brought down short-term interest rates by 300 to 400 basis points. And, unless I am as blind as a bat, I don't

think that that is all wrong. Excuse me, Mr. Chairman, but in sum, I would opt for alternative B.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I come from a very different position, but I'm going to get somewhere near Larry's. I should begin to think about that; I wonder if my logic is as tight as it ought to be! We have made a lot of progress against inflation but I don't think the battle is over yet by any means. I think the recent numbers on the actual PPI and CPI changes overstate considerably where we are in terms of the underlying [inflation] rate. And, indeed, the underlying rate itself has come down because of this very, very severe pressure on labor markets. But I think we've made enough progress to have gained some credibility and it's time to let the economy grow at a restrained pace and still make progress against inflation.

I expressed earlier my deep concerns about the possibility that we might inadvertently push the economy off the cliff. That should be one of our major concerns now as well as doing what is necessary to make continued progress against inflation. However, the room we have to maneuver is very, very limited because of what is happening in fiscal policy. It is true, as Governor Teeters says, that the present deficits are primarily recession deficits; but is not true that the deficits we're looking at beyond, say, the coming fiscal year, have anything to do with recession. The budget deficits projected for the out years take place--and are growing--in the context of a fairly well functioning economy. Indeed, our staff is forecasting by way of a change in the high employment deficit between the first half of '82 and the last half of '83 an \$87 billion swing; that's over a period of six quarters. And, of course, it gets bigger and bigger as far out as one can go. That is horrendous fiscal stimulus in process if we do not see a compromise reached that has some meaning to it. I think Mr. Kichline's words are well taken; he said that these unspecified budget cuts being talked about are not going to convince anybody. That is having a negative effect on the economy now because of its impact on expected future interest rates and on some present long-term interest rates. If we were to engage in any actions that suggested, in effect, that we were throwing in the towel, I think the effect on public expectations would be extremely adverse.

So, I think we have a little room to maneuver and we ought to use it. We are doing basically what we wanted to do in the second quarter; things are coming out about as well as we could have expected. The money growth rates are about on target and interest rates have inched down a little from where they were. So, I would like to stay about where we are--that is, about "B." I might lean a little in the direction of Ed Boehne, going toward "B+," but I wouldn't want to go far enough in that direction to generate a substantial downward movement of interest rates. Although that would be nice from the standpoint of the economy, it would be adverse from the standpoint of public expectations and would take some of the pressure off Congress and the Administration to get something done while there's still time.

MR. MARTIN. Governor Rice.

MR. RICE. Well, Mr. Chairman, I don't believe that the alternatives we're looking at have much to do with inflationary expectations. Whichever of these alternatives we might choose, I don't think it would have very much effect on inflationary expectations. I just don't think many people out there are greatly worried about the fires of inflation being reignited in the immediate future. So, I don't think that's the issue. The question is how quickly we want to return M1 to the upper end of its target range. I share the view that has been expressed that our main problem is to try to do what we can to get interest rates down. My own view is that there is not much we can do to get interest rates down. If we take alternative A, the most we can look to is a funds rate of around 12 percent; I think the estimate is slightly above 12 percent. That's not a very low funds rate with unemployment at 9-1/2 percent. And with a recession of the kind we're looking at and with the economy in the shape that was described by Governor Gramley, that's not what I consider pushing interest rates down to the levels that the economy needs in order to begin recovery.

What we can do, though, is to create an environment in which interest rates can fall more easily than they can rise or where they would be more likely to fall than stay where they are. The only one of these alternatives that increases the likelihood that rates will fall is alternative A. And alternative A really just returns us to the target range at a later date. We're still approaching the target range. And if we don't get there until the second half--the end of the third quarter or the beginning of the fourth--I wouldn't be greatly worried as long as we're facing the kind of economic conditions that we're facing now. So, I would opt for alternative A in the hope that it might encourage--though it may or may not--some downward movement in interest rates. Along with that I would like to see a funds rate between 10 and 15 percent and borrowing in the \$500 million range.

MR. MARTIN. Thank you. Mr. Timlen.

MR. TIMLEN. Mr. Chairman, I think the Federal Reserve has demonstrated over time--what to many of us seems a very long time--its commitment to its objectives. Today the credibility of the Federal Reserve in terms of that commitment is not at issue. We all recognize that the country has had some success in its war against inflation. But I think this Committee must also recognize that we are encountering a very weak economy. Against that background, the Committee should avoid any dramatic action of easing. I fear that any such dramatic action would be misinterpreted and would stir up inflationary expectations. I do think those inflationary expectations are a real risk in the financial districts, particularly as they contemplate the outlook for the federal deficit. I must state that my thinking is quite close to Ed Boehne's, which will probably make him rethink his position! I do, however, like alternative B. I might shade it slightly in the direction of alternative A and that shading in my mind would be in terms of, say, shooting for borrowings around the \$700 million level rather than the \$800 million level indicated.

CHAIRMAN VOLCKER. Maybe just for my benefit--I am sorry I got called out here--your concluding comment was "B," I take it?

MR. TIMLEN. Shading a little toward "B+" but not much.

CHAIRMAN VOLCKER. I didn't hear any of Governor Rice's argumentation. You reported that you were for "A"?

MR. RICE. In a nutshell, I was saying that none of these alternatives can be described as easing. And I just cannot believe that any of them--alternative A at the extreme--would set up any serious inflationary expectations. People are not worried about inflation now; they are worried about staying alive. And alternative A stands the best chance of allowing interest rates to come down somewhat, though it probably won't even accomplish that.

CHAIRMAN VOLCKER. I hope I don't get called out again. I should report that the market on the surface is behaving normally enough. Bond prices are actually up today. I guess the federal funds rate hasn't behaved very well; it remains around the same level or a little higher, but I don't think that has anything to do with this little flurry in the market. I wouldn't think the funds rate is affected. We get contrasting reports about whether the market clearing arrangements are affected. They are not drastically affected at this point, but there's a lot of nervousness about them. And still nobody knows anything about the position of this firm, as near as I can figure out. So, so far so good.

On policy, I was going to interject a few comments of my own here. I don't know whether it's time to do that or not but I heard some concerns, which I well understand, and I heard various bits of analysis. I'm sorry I missed the earlier discussion. I think we are in a stage where we could tell ourselves that nobody said it was going to be easy to change these expectations and behavior patterns. I don't think we have changed them completely. We have a situation where prices are moving much more favorably than can be sustained on the basis of cost trends, and we have costs rising at a somewhat slower rate of speed, but a modestly slower rate of speed. There is a real prospect, I think, of further progress in that direction over a period of time. It is going to take some time and we can't count on surface price improvement to continue. Meanwhile, there's a horrendous squeeze on profits and all the manifestations of that around the economy. And I think we are vulnerable to the kind of thing that is happening in the market now in some form of another as time passes. I would also be concerned, and have been for some time, about influences on M1 of the liquidity/uncertainty/precautionary motive that Steve referred to. Did you refer to this survey? I didn't hear it.

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. We can always reevaluate our longer-range targets at any meeting. I haven't heard anybody pressing that at this meeting and I think that's probably appropriate because it's very normal to do it at our next meeting. But we have to do it with some care at the next meeting, particularly against the background of the behavior of M1. Steve has outlined the possibility that M1 growth will be quite modest as soon as the economy turns around and as the precautionary motive unravels. I think there's a reasonable chance of that happening. It probably will once the economy turns around, but that assumes that it turns around and, of course, that people perceive that it has turned around. It is devoutly to be wished at this point that interest rates come down. And even more so, I don't think we

have much leeway for surprises in the aggregates that drive [interest rates] up through a too mechanistic interpretation of the aggregates.

I put this all together in two ways, which isn't unique from the comments I've heard already. I've argued the case before--not always successfully--that unless we have a good reason, we shouldn't change the quarterly targets. However, there are all sorts of ways to interpret that and the operational decision is where to set the borrowing path. I don't know whether Steve is right or wrong; I presume that there's at least a 50-50 chance that he's right that a considerably lower level of borrowing will be accompanied by a growth path in the aggregates that is consistent with the target we already set. In any event, that is basically a two-track strategy that has some appeal to me. Fine-tuning the aggregates in the middle of a quarter I'm not sure buys much. I am not going to [be greatly upset] if M2 growth comes out at 8-1/2 percent instead of 8 percent or even 9-1/2 percent instead of 8 percent or if M1 continues to run somewhat high under a pattern of liquidity pressures as reflected in NOW accounts in particular. I'm right in the middle of something, tell him I'll call him back in just a minute. [Secretary's note: The previous sentence was an aside to a messenger informing the Chairman of a phone call.]

In effect, I would at this point take the chance from one point of view or buy the protection from another point of view--however one wants to express it--of easing the pressures on bank reserve positions along the lines of plus or minus what is suggested in "B." If it turns out that the figures are more favorable in terms of restrained growth, we could move more aggressively pretty promptly. I think that would bring some easing sooner or later in the funds rate. The borrowing is substantially lower than we've had for a long time. But I am not persuaded that that has to be reflected in precise changes in the targets. I'd be inclined to leave them where they were and then take the chance that that will turn out to be consistent with an easing of money market pressures for which I think there is a reasonable chance. That's how I'd play the risk situation. There is a risk in the sense that whenever we set these reserve paths we never quite know where M1 and M2 and the rest of the Ms are going to come out. I'd play it in the sense that we will take some chance that with a lower borrowing figure, they will behave. If they don't behave, we might have missed a little low on the borrowing side but we don't have to react too quickly on the other side either if there's no very extreme movement within the confines of any of these numbers we're talking about. Well, with that much introduction or comment, I will make a telephone call and return very promptly. Next on the list is Mr. Ford.

MR. FORD. I come out right about where you do, Mr. Chairman. I like "B." I'd like to see the federal funds rate range widened somewhat. I would not be concerned, as Lyle is, if rates were to drop now. I don't see why rates can't drop, with the high level of real interest rates that we're currently suffering under, toward a single-digit range. That ought to come sooner or later, so I'd want to widen the band, certainly on the lower end. And given the uncertainty that we're facing presently with the Drysdale situation, I'd perhaps just widen the band on both ends. I always like to do that. And a borrowing assumption of \$800 million to \$1 billion, or somewhere in there, sounds reasonable to me. I am concerned that we not go too far

beyond "B" toward "A" because we don't yet know what will happen as we get into the second half of the year, and I wouldn't want us to give up all our leeway as we look ahead to the second half of the year. My feeling is that we should go generally for "B" with a somewhat lower initial borrowing assumption, though not a lot lower than we had last time, and a wider fed funds range--dropping [the lower limit] down to perhaps 10 percent and making the range, say, 10 to 16 percent. That would widen the range to 6 points as we had it some time ago. It would allow for more unusual variability [given] the current conditions that we face with the special situation in the market.

MR. MARTIN. Governor Partee.

MR. PARTEE. Well, I think we do need to review the long-range targets. A very, very large proportion of the increase in M1 since the beginning of the year has been in NOW accounts. I think it's 85 percent. I had that number someplace but I can't find it now; but it's a very large proportion. That is suggestive of the possibility of a change in precautionary balances that might not continue, but at least we shouldn't try to offset the lower growth rates for something that occurred in the early part of the year and is already water over the dam. I also didn't know that Argentina accounted for million of the money supply increase in April. That takes off a good deal of the strength in currency this year. I thought that April bulge indicated that people were spending. All that increase in currency indicates is that the Argentineans are afraid they might have their money taken away from them. We should make allowance for that kind of thing, and that's going to continue for some time into the future.

As far as this meeting is concerned, I'm also attracted to continuing on the target path that we set at the beginning of the quarter, which is alternative B. It calls for an increase in the money supply in June--May is largely over and seems to be minus--of 4.3 percent or thereabouts and continued expansion in M2 throughout the quarter. I'd be most concerned if we didn't get that June increase. Last year we didn't, if you recall; money growth in June was very weak. And we ought to be prepared to move in case weakness develops as we go through the period. So, I would take "B" for this time but reserve [my options] on the question of respecifying the aggregates for the year, which we'll be doing at our early July meeting. I rather like Mr. Ford's idea of widening the [funds rate] range. I wouldn't look forward to a 16 percent funds rate; on the other hand, I do think it could drop as low as 10 percent. So, I would widen it just on the lower end and make it 10 to 15 percent; and I'd choose a beginning borrowing number that is somewhat skewed in the direction of encouraging lower rates, which is probably around \$700 million. I would agree with you on that, Tom. In sum, I would take \$700 million as my initial borrowing figure, 10 to 15 percent for the funds rate range, and the aggregates as specified in alternative B.

MR. GRAMLEY. I have the numbers that Governor Partee was looking for. Of the \$11.8 billion increase in seasonally adjusted money supply from December to April, \$11.7 billion came from other--

MR. PARTEE. Oh, is that right? It's almost 100 percent. I see.

MR. GRAMLEY. From the fourth quarter to April would be the numbers that you had, I think.

CHAIRMAN VOLCKER. Mr. Martin. Is that who we're up to?

MR. MARTIN. Yes sir.

CHAIRMAN VOLCKER. Was there any particular comment of great acuteness that the two last people wanted to repeat very briefly? I see where you came out generally. If not, Mr. Martin.

MR. MARTIN. Thank you, Mr. Chairman. I think we have to be aware that there are limits to the impact we are going to make on this recession at this time with "A" or "B" or whatever set of targets we choose. We must be careful to keep in mind that in addition to a recession, the recovery from which is highly complicated by the level of interest rates, we are also undergoing in this country several structural changes in the overall national economic base. And those structural changes are not entirely responsive to monetary policy. It is obvious that we are in the process of moving from a heavy industry, smoke stack, economy to a service economy. We're well along that path. The difficulty of utilizing a more liberal monetary policy to bring us more strongly out of this recession is involved in that. Much of what we've read in the Redbook, District by District, has been about the changes occasioned by primary employment contraction. And that, of course, produces a multiplied effect on the economic base as secondary employment is hit by that. I submit to you that until our structural changes are farther along in that economic base we will have a weak recovery and that our policies here will have only a limited impact.

Furthermore, we face changes in the financial structure in this country of which we all are acutely aware. Those changes are resistant to monetary policy in the sense that the departure of the life insurance companies and the other long-term investors from the financing of industrial plants, industrial parks, and office buildings --their abandonment, if you will, of the debt side of that kind of growth in private domestic investment--is not going to be turned around by what we do here. Those investors are going to equity participations, and in many cases that means that the factory building won't be built and the computer facility won't be installed and the office building will not be constructed, and that's not going to turn around. That is a structural change that has to work its way through until there are additional long-term sources of funds to finance business investment. The same comment applies to housing and housing-related investment--I'm stretching that term a little. The thrift institutions are not going to recover. "A" or "B" is not going to affect their financial health materially. Lower interest rates will help, but we can't get interest rates low enough, long enough, to bring the thrift institutions back as the primary financers of housing. That is not going to occur. So, those are some of the structural changes.

There has been another structural change--I use words any way I like when I have the podium, and I may be cut off any second here for that remark--and it is in federal fiscal policy. It is not entirely the province of one political party. The old days when a \$5 or \$10 billion dollar appropriation would have bounced through the

Congress to revive housing are behind us. When a \$1 billion-a-year program is called generous in terms of a level of housing output of 1 million units, you know we have a changed structure there. I don't believe this Administration or its successors will get back into the bail-out of the Chryslers and the Lockheeds and so forth. So, ready federal spending in multi-billion dollar amounts is another structural change, and that has implications with regard to the recovery.

I note--maybe I was too many years in the supervision of financial institutions--that I am very sensitive to the upcoming financial crisis that we will have, and I know many of you share this view. Drysdale is just one; there are going to be a number of others. There are thrift institutions that are greatly overextended--and they are multi-billion institutions and they are heavily dependent on large CDs. They are buying all the junk assets they can find because of the fees and the yields on those, which are coming down; they will fail. They may get through this interest cycle but they won't get through the next one. So, from time to time we're going to have to inject reserves. From time to time, or over and over again I should say, we're going to have to play the lender-of-last-resort role; and that is going to persist for some years. I'm not sure that it will be the Penn Central [situation] all over. I don't know that history repeats itself that way. I think the recent bulges in the reserves that we provided and in the various measures of the money supply won't go away because there's going to be another wave behind that first wave. I don't believe that the markets believe us entirely. I think we have a great deal more credibility than we used to have, but don't tell me that part of the disbelief is not reflected in the level of interest rates. I feel there is still disbelief and it is so reflected. Of course, the awareness of how the Congress works is reflected in financial markets. The perfectly normal, usual, ordinary historical process in the way Congress grinds along and finally produces a budget hasn't helped us any in the interest rate situation. I don't put much weight to polling results, but there was a recent poll of 1200 families around the country who were asked if they believed that inflation has come down recently. About a quarter of them said yes, we believe inflation has come down recently and about 75 percent of them said no; and some of them said it has gone up! So, do they believe us? Do they believe in the effectiveness of our inflationary policy? No.

It is those considerations that get me over to "B," not "A." Absent the structural changes, absent the disbelief, absent the necessity for us to be the lender of last resort, I'd go for "A," frankly, because our credibility is high enough and we've been able to go from numbers of \$4.9 billion in the M1 weekly changes and have gotten through that without the markets being that disturbed. I'm trying not to repeat what my colleagues here have said because they so well covered the other aspects of the economy and the price situation and the growth in the aggregates. I'm just trying to add a particular view here. Given the situation as I see it, I would go to "B," but I would hope that with the excellent job done by our colleagues at the Desk--and here I'm second guessing the Desk, if I may put it that way--that if the numbers came in a little high, they would be left a little high. I hope it would be "B" but an easy "B" rather than a rigid conformance to these numbers, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Well, I guess I ended up as tail-end Charlie, today. Did I?

CHAIRMAN VOLCKER. Nope.

MR. BALLEES. I'll try not to repeat some of the views that have already been expressed because I agree with a number of them. I would like to go back to Mr. Axilrod's analysis. That suggests that perhaps we should extend the strategy of allowing a bulge in M1, much as we did in April, and that because of the possible increases that may have occurred in precautionary balances, because of the recession, etc. we should in effect give more emphasis to M2. We agreed in April that we would [accept an overshoot on M1] provided that M2 stayed essentially close to its target for the year. Of all the different options that we might choose that's the one that appeals to me personally as making the most sense at this time. All of us are extremely anxious, of course--if we knew how to do it--to get interest rates down. The question is: How can we, in fact, do it? I'm afraid my perception is that there is probably more of a risk in big overshoots in terms of getting inflationary expectations up again, and hence interest rates up, than the risks we otherwise would run. That was more or less confirmed in my thinking at the meeting last week of the Committee on Investment Performance where we talked to three insurance companies and five investment counselors who handle our retirement fund. I asked each one of them their explanation of why nominal rates are staying so darn high in view of a very significant decline in the actual inflation rate. The answer was pretty much the standard one about the fear that these big deficits will at some point result in the Fed monetizing a good part of these deficits again, recreating inflationary pressures, and thus double-digit interest rates reappearing.

Coming down to the bottom line, in view of the conflicting pressures on us, I would favor alternative B for M2, but I would be prepared to be a little more generous on the M1 side depending on the unfolding evidence of this continued buildup in precautionary balances. As Messrs. Black and Guffey pointed out, however, that \$800 million borrowing assumption could be a little too generous to keep M1 from getting too much out of hand on the up side. The work that we've done in our Bank on the short-run effects on M1 of the rate of bank loan growth suggests that we might need a higher level of borrowing--say, around a billion dollars--to keep M1 from growing too fast. As far as the federal funds rate is concerned, I would join those who would broaden the range just to make sure we have all the bases covered. I would suggest a federal funds range of 11 to 16 percent.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, it's a difficult choice. It's interesting: Alternative C certainly doesn't seem to have had any friends today. Given the gains that we have achieved on the inflation front and, most importantly, given the current state of the economy, I do think we are at a point where we could provide some room for the economy to grow and hopefully some scope for interest rates to go down. Since most of the growth in M1 so far this year has been in OCDs as opposed to currency and demand deposits, it seems to me that we could provide some scope there. I would be in favor of alternative A, and I do think we can accomplish that without any significant adverse reaction.

We simply will be getting back to the target at a later date, and in my view there would not be undue negative reaction on the part of the markets. I'd stick with the funds rate range of 10 to 14 percent. That kind of band has been appropriate so far and I don't see any particular reason for making a change in that now. A borrowing level of, say, \$500 million would be appropriate.

CHAIRMAN VOLCKER. Governor Wallich, you have your chance to defend "C."

MR. WALLICH. Well, I would like to remind you that this is probably the low point on inflation that we're going to reach in this cycle. From here on out visible inflation--[as reflected in] the indexes--is going to rise. I know that the underlying inflation rate isn't as low as the indexes show and that that underlying inflation is likely to continue coming down. Nevertheless, from now on out the newspapers are going to be reporting that inflation has started again. Who was it that did it? I'll give you three guesses!

So, I fear that we're in some danger of repeating past performance and that we may shift to an accommodative if not expansive stance too early. And things need not improve, unemployment wise, under such a scenario. Mrs. Thatcher now has 12 percent unemployment and she had up to 20 percent interest rates. That may happen to us the next time around if we start the next expansion from the present level of inflation. I do agree with those who say that our job is to get interest rates down. We need to get credibility for what we've been doing. Interest rates in real terms are surprisingly high and I think this is largely because people don't trust what has been accomplished so far. They see inflation accelerating again. They look at inflation as something on the order of at least 10 percent per year over the long run. I don't see great [problems] in maintaining a degree of pressure at this time. Monetary policy really hasn't been very tight given that it is operating at very high interest rates. We're above our M1 target. We have not made a dramatic effort to get back into it as we did a year ago in April. The concerns that the targets might be too low to accommodate a reasonable rate of growth of nominal GNP have been largely removed. We're now looking at nominal GNP growth of 6 to 7 percent; a target at a peak 5-1/2 percent plus a normal gain in velocity of 2 or 3 percent clearly would accommodate that and even would allow, possibly, for some decline in interest rates.

Finally, the danger of provoking a severe downturn seems to me to be protected against--not guaranteed against, obviously--both by the endogenous workings of the economy, such as the inventory turnaround, financial endogenous factors such as the possible drop in interest rates if the economy stays very weak, and the exogenous factors of the tax cut and social security increase. So, it seems to me that we could continue to pursue a policy of moderate restraint until the economy turns. I would lean--I'm not always to be going for "C"--toward something like "B-." That would mean to me a funds rate range of 11 to 16 percent instead of the 12 to 16 percent associated with "C;" I'd shade the range on the low side because we do want to get rates down. And for the borrowing assumption I think \$800 million is peculiarly low and I would opt for something around \$1 billion. Thank you.

CHAIRMAN VOLCKER. A billion dollars is where we are now in fact.

MR. AXILROD. Well, that's where it is implicitly; we've never been there. Last week the borrowing averaged \$914 million or so and thus far this week it has been just a shade under \$800 million.

MR. BLACK. Peter, as to our operations, you said yesterday on the call that the Desk anticipated that we would hit our borrowing targets of a week ago.

MR. STERNLIGHT. The level implicit in the path is a little over [\$1 billion]--about \$1044 or \$1045 million. But, as Steve said, borrowing has been running around \$750 to \$800 million so far this week.

MR. BLACK. But would your guess still be that you'd come out about on the borrowing target? Or has that changed since yesterday?

MR. STERNLIGHT. I don't know. The way borrowing has been running I wouldn't be surprised if it stays around that \$800 million level today because tomorrow we may be looking at something that's averaging \$800 million. Now, how we shape operations tomorrow might depend on the decision reached here today. If the borrowing assumption were to come out around that \$800 million level, let's say, I'm not sure there's a great point in obliging that final day of the week bulge in borrowing that would bring borrowing up to the \$1040 million average.

CHAIRMAN VOLCKER. Well, borrowing, let us not forget, is in any case the residual; what we are aiming at is the reserve path. And if the excess reserves vary from their assumed level, we will get a different borrowing figure simply because excess reserves are off.

MR. BLACK. The only reason I asked the question is that I was on the call yesterday and the staff thought at that time that we'd probably be about on target. I just wondered if that had changed.

CHAIRMAN VOLCKER. Mr. Boykin, would you like to contribute to our--?

MR. BOYKIN. Briefly, I would opt for alternative B. I would do it in a fairly firm way. I don't think I'd want to see it shaded toward "A." I would accept the borrowing assumption of \$800 million. It seems a little low, but I would accept that.

CHAIRMAN VOLCKER. Mrs. Horn, you are left either to pronounce the benediction or to change everybody's mind, or to bring a fresh point of view in any event. I don't know whether your view is from Cleveland or Philadelphia at this point--perhaps a mixture of both.

MS. HORN. The point of view is Cleveland as of a few days ago. I would choose alternative B. If we're either on alternative A or [C], it seems to me we run the risk of the market--or of all of us --being surprised by another accident in the money supply when we're above target. I think that's particularly damaging to market expectations. I believe the market expects us to stay on the track

that we seem to be on for this quarter and would not be disappointed by our continuing with alternative B. My staff's work would indicate that the \$800 million initial borrowing assumption would shade this path toward "B+," but basically alternative B as specified is where I come out.

CHAIRMAN VOLCKER. Well, we seem to have some considerable, but not unanimous, consensus around some variant of "B" with a plus or minus [or] in the middle. I take it a number of people have made the point, and I made the point, that we face the possibility of surprises and uncertainties along the line, which might require a deviation from a strict application of a reserve path. But we have to assume we're talking in the usual manner. There is one consideration that would bear upon me, which I didn't mention earlier, and I don't know whether anybody mentioned it explicitly. I'd like to get interest rates down; it wouldn't hurt my feelings at the very least to give the market a little sense of a lead in that direction. On the other hand, it would be unfortunate if we gave it such a strong lead and created a sizable risk that we would have to reverse it in a considerable way. That would damage precisely what we're trying to do; we always have that risk to some extent.

Borrowings have been around \$1 billion and very briefly have been a little below that. Actually, the Desk has been aiming at a path consistent with \$1 billion. Such a level has been very slow to affect the federal funds rate so far, but presumably at some point it should. The federal funds rate is about where it was when the borrowings were \$300 or \$400 million [higher]. Sometimes it takes a few weeks. All I'm saying is that, balancing all this out, maybe the \$800 million in the Bluebook is a reasonable compromise between a bit of a lead and not being so aggressive that we maximize the chances of having to turn things around on relatively short notice. I really hadn't thought of it before particularly, but as I sit here, I feel that if we promote a great rally in the bond market and have it disappointed in three weeks, we may be better off with a little more moderate increases in the first place. We can't control that because the market has a mind of its own. We can't control it fully, but we can try to avoid giving a false lead. And if we have to go lower [on the borrowing], I'd go lower a little more gradually. That is my sense of that.

As for the federal funds rate, it's hard to put the limit below 15 percent when it's above 14 percent right at the moment. But I would not have a comfortable feeling if the federal funds rate went above 15 percent at this particular juncture, and I would want to review that pretty carefully. I am inclined to think we ought to say 15 percent; we should review it if it goes to 15 percent. I wouldn't expect it to do so but I would want to think a bit if it did. The lower end of the range on a 4-point range comes out to 11 percent, which gives us a lot of room from where we are. I don't feel strongly about the lower part of the range. But just to give you something to shoot at, we're at "B." And, picking up on John Balles' point, which I think had some echoes elsewhere, I personally do feel more relaxed about M1, given the various influences or uncertainties bearing upon M1 within limits. It's a great source of comfort that M2 is somewhere near the upper end of the range. I have made this point very frequently in informal public and private discussions, though I have not done it in writing or in a big public speech. I think it might be

useful at least to suggest in a public speech, of which I have a plenitude still on my calendar, that one should not be too literal or too aggressive about M1 when there is all this uncertainty about the precautionary effects in M1 and so forth. I also would note that that figure gets interpreted in the light of what is happening in the other aggregates and is not looked at just as a figure itself.

I have to discuss a bit a letter from Mr. Reuss discussing various resolutions in Congress and what we would do about them. I want to take that up with you. I can do it now or after we make this decision. I don't know whether it's relevant to anybody's decision. So, let me just introduce it. I have been abroad, but he sent me this letter, which arrived on my desk Monday morning, May 12. That means it was sent on Friday. It's a six-page opus. Page 1 says the Senate Budget Committee has tentatively adopted a budget resolution and he's urging the House Budget Committee to have [such a] resolution; they hadn't adopted it at the time he wrote this letter, I guess. Since then the House Budget Committee, in Committee stage, has adopted the same resolution, with the same language as the Senate resolution. It says that it is the sense of the Congress that if the Congress acts to restore fiscal responsibility--that's a big if--and reduces projected budget deficits in a substantial and permanent way, though I don't know how one makes that judgment, then the Federal Reserve's Open Market Committee shall reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy. It seems to me a fairly unexceptional kind of resolution and one that can be lived with, since it's entirely appropriate that we reexamine our targets on our own initiative with or without the Congress speaking for this and for other reasons. Obviously, we are approaching the midyear date to make that an explicit part of the [agenda].

Now, Mr. Reuss has been trying to get in a much more specific resolution, and page 2 reviews the background for that. He [unintelligible] it in other ways; he didn't say how specific a directive or resolution at least, but it comes down to a more specific resolution. He says he thinks that is going to prevail when the budget resolution is finally enacted. That's not the resolution they adopted in the Committee. He says here or elsewhere that he's going to press it as part of the debt ceiling legislation. If it appears there, I would note that that is legislation and not just a resolution. Then he has 2 or 3 pages about how the Constitution says that Congress shall have the power to coin money and the Federal Reserve is its agent. He notes that that is in the preamble of some resolutions that he has introduced and he reviews [comments by] past Chairmen [of the Federal Reserve]. I don't know whether he quoted some language from me--he could have; somebody should look it up--but he could have mentally, though he didn't. But he quotes Mr. McCabe, Mr. Martin, and Mr. Burns as saying that yes, indeed, if Congress appropriately by law ordered the Federal Reserve to do something, the Federal Reserve would do it. I don't think he gets right to the point of what we would do if there were a resolution. [He says] it is vital for the Congress to know whether the Federal Reserve will now accede to the directive of Congress or instead assert that it is a fully independent fourth branch of government accountable to no one. [He notes that] the next meeting of the Federal Open Market Committee is on May 18 and that it would be in the public interest to give the Open Market Committee an opportunity to vote on this question. So, I'm

going to ask you to vote on--not seriously--whether we will obey the law or not.

He suggests a rather vague resolution--well, I don't know whether it's vague or not: "Resolved that the Federal Open Market Committee will comply with a directive in a concurrent resolution requesting the Federal Open Market Committee, if the Congress substantially reduces budget deficits, to adjust its present monetary target range in order to permit lower interest rates." That leaves open the question of whether adjusting the monetary target range will in fact speed up the achievement of lower interest rates or not; that is a matter of some controversy. I do not think it's appropriate that I take a vote on this particular resolution that he has proposed, but I wanted to expose you to it. And I wonder whether I can report to him that we have discussed this matter and I will tell him that it is clear in the minds of the members of the Open Market Committee that indeed we follow the law. If Congress had a law that told us to do something, we'd have to do it. But a resolution is a much more tricky thing to handle. I think we probably ought to duck the question of how binding a resolution is, in the last analysis. But obviously we'd have to take it seriously and I'd say so. I would propose to point out in a letter that it would be a very difficult matter if they got very precise in a resolution. It would be a departure, I think without precedent, if there were a really precise resolution. It would create a very serious dilemma if we didn't happen to agree with him. But I would not say what we would do. However, I would like to report that we take their [views], however expressed, very seriously and would certainly give them our fullest attention without [directly addressing] the issue of whether we really would feel compelled if they say that our target should be 8 percent or whatever, to say that our target is 8 percent.

MR. WALLICH. I would stress the difference between the law and the resolution. If they pass a resolution, it seems to me clear that they didn't want to pass a law.

CHAIRMAN VOLCKER. Well, one hears all kinds of mixed arguments. I don't disagree with you in one sense. But it's not quite as simple as that, I'm afraid. They can put resolution language in a law. If it is resolution language, such as "It is the sense of the Congress that the Federal Reserve ought to do something," which doesn't sound like a law, but is signed as a law, what do we do with it? There is also the more subtle question, when we have always claimed that indeed the Congress has the power and that's in the Constitution and all the rest, of whether they need a law if both houses pass the same resolution. I just don't want to meet that question at this point. It would pose a very difficult issue for us.

MR. ROOS. Can't you respond just by transmitting to him some sugar-coated, beautiful, unadulterated, double talk? I don't think you have to dignify the gentleman's request. Frequently in the game of politics when somebody tries to put you on the spot, you respond in a very dignified way with some vacuous terminology and hope he makes an inspection trip to the Falkland Islands or something like that!

CHAIRMAN VOLCKER. He's not likely to do that. My own judgment is that we can't evade this issue that fully. He's going to come back. He's going to come back in another letter or hearing very

quickly if he thinks our response is too obviously evasive. Now, at the same time, I don't think we can answer the question. And we should not, in my opinion, prejudge precisely what we would do without even knowing what the resolution is.

MS. TEETERS. We also run the danger that if we don't pay some attention to the resolution, they will pass a law.

MR. PARTEE. I'd be very much impressed by a resolution. After all, this is not just any Congressman; this is the Chairman of the Joint Economic Committee, the ex-chairman of a Banking Committee, and a Congressman who has announced he is not going to run for reelection. If he can get the whole Congress behind him to support a particular path for monetary policy, as long as it's not too specific, I would take it extremely seriously and be inclined to vote with it.

CHAIRMAN VOLCKER. There is no question that they will pass a resolution. The sentiment is very strong. The question is whether we will get a resolution of the type that the Committee has adopted, which I think is the probability. The danger is something much more specific. But it depends upon whether it's said precisely; I don't think we can answer. It could put us in a very great dilemma. It has to be taken seriously; I don't think there's any question about that. Also, some of us have to go to a lunch and we have to quit for the time being. Maybe we can think about this over lunch and come--

MR. ROOS. Do you have some idea, Mr. Chairman, when we return how long you think [the meeting will run]?

CHAIRMAN VOLCKER. Well, I don't think it's going to take very long, because I think we were very close to concluding. We have to resolve this issue in general terms and I don't think we will need more than a half hour, I would guess, and maybe less.

MR. GUFFEY. Would it not be possible to take a vote now on the directive? There's a consensus probably on the resolution as you have outlined it.

CHAIRMAN VOLCKER. Well, okay, if you're willing to go that fast. Let me just repeat. What I'm suggesting is that I would prefer just to keep the wording of the directive with a modification in the time period. That's where we are. Instead of just rewriting it, we'd have the same substance with a different time period. I would take out those intermediate sentences that we had before and just say this is it. I'd make clear, not in the directive but in the interpretative language on the Committee discussion--the policy record or whatever we call it--these nuances that we're a little less worried about M1 and that if it went a little high we wouldn't be all that concerned, particularly provided M2 is okay. I'd leave that to the policy record. Is that what it's called?

Mr. Altmann has suggested that we put in a phrase that for the short run the Committee reaffirmed its decision of the previous meeting. It's 50-50 for me. We are in one of these peculiar cases where we are right on track with what we said at the previous meeting in terms of the aggregates. We can leave in that first sentence--well we can't really say the tax date--but we can leave in the sentence

saying that M1 is affected by these liquidity shifts and so forth, if we want to.

MR. GRAMLEY. I think that would be a good idea.

CHAIRMAN VOLCKER. I don't have the precise language. We'd have to modify that language.

MR. GRAMLEY. All we have to do is to make it: "The Committee also noted that deviations from these targets should be evaluated in light of changes in the relative importance of NOW accounts as a savings vehicle." Just cut out everything from--

CHAIRMAN VOLCKER. Okay. That's consistent with--

MR. GRAMLEY. Just drop the next sentence.

CHAIRMAN VOLCKER. Drop the next sentence. The borrowings are \$800 million and the funds rate range is 11 to 15 percent, if that's the most natural thing to say here. Do you want this clause saying we reaffirmed? I'd be inclined to leave it out.

MR. PARTEE. How would you like 10 percent for the bottom of the funds range? There was some expression around the table for that.

MR. BALLES. What did you say on the federal funds rate?

CHAIRMAN VOLCKER. I said 11 to 15 percent. Governor Partee is suggesting 10 to 15 percent.

MR. BOEHNE. I prefer 10 percent. What do we have to lose by letting it go to 10 percent?

MR. MARTIN. Let's go to 10 percent.

MR. PARTEE. You might ask for a show of hands or something.

CHAIRMAN VOLCKER. Well, I'll see. Is that the majority sentiment--to go to 10 percent? It seems to have a fair amount of support. That's the proposition. Is it clearly enough understood? We will vote then.

MR. ALTMANN.

Chairman Volcker	Yes
President Balles	Yes
President Black	Yes
President Ford	Yes
Governor Gramley	Yes
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Teeters	No
Governor Wallich	Yes
First Vice President Timlen	Yes

END OF MEETING